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BEFORE THE ARIZONA CORPORATION

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Arizona Corporation Commission

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AZ CORP COMMISSION  
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COMMISSIONERS

MIKE GLEASON, Chairman  
WILLIAM A. MUNDELL  
JEFF HATCH-MILLER  
KRISTIN K. MAYES  
GARY PIERCE

IN THE MATTER OF THE APPLICATION  
OF ARIZONA PUBLIC SERVICE  
COMPANY FOR AN ORDER OR  
ORDERS AUTHORIZING IT TO ISSUE,  
INCUR, AND AMEND EVIDENCES OF  
LONG-TERM INDEBTEDNESS AND  
SHORT-TERM INDEBTEDNESS, TO  
EXECUTE NEW SECURITY  
INSTRUMENTS TO SECURE ANY SUCH  
INDEBTEDNESS, TO REPAY AMOUNTS  
PAID UNDER ANY PINNACLE WEST  
CAPITAL CORPORATION GUARANTEE  
OF ARIZONA PUBLIC SERVICE  
COMPANY INDEBTEDNESS AND FOR  
DECLARATORY ORDER

DOCKET NO. E-01345A-06-0779

**NOTICE OF WITNESSES AND  
EXHIBITS**

IN THE MATTER OF THE APPLICATION  
OF PINNACLE WEST CAPITAL  
CORPORATION FOR AN ORDER OR  
ORDERS AUTHORIZING IT TO  
GUARANTEE THE INDEBTEDNESS OF  
ARIZONA PUBLIC SERVICE COMPANY

Arizona Public Service Company ("APS" or the "Company") and Pinnacle West  
Capital Corporation ("Pinnacle West"), co-applicants herein, hereby give notice of the  
following list of witnesses and exhibits that they intend to present at the scheduled  
evidentiary hearing in this matter on July 23, 2007.

Witness: Barbara M. Gomez, Vice President and Treasurer, APS and Pinnacle  
West.

Exhibits (attached hereto at Tabs 1-3):

1. Verified Application, filed on December 15, 2006.


1 2. APS Comments on Staff Report, filed on May 29, 2006.

2 3. Public Notice of Hearing, filed on July 6, 2007.

3  
4 RESPECTFULLY SUBMITTED this 18<sup>th</sup> day of July, 2007.

5  
6 PINNACLE WEST CAPITAL CORPORATION  
7 LAW DEPARTMENT

8 By:

  
Thomas L. Mumaw  
Meghan H. Grabel

10 Attorneys for Arizona Public Service Company

11  
12 SNELL & WILMER, L.L.P

13  
14 By:

  
Matthew P. Feeney

16 Attorney for Pinnacle West Capital Corporation

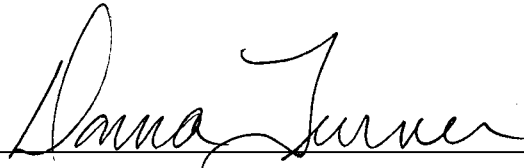
17 ORIGINAL and thirteen (13) copies  
18 of the foregoing filed this 18<sup>th</sup> day of  
19 July, 2007, with:

20 Docket Control  
21 ARIZONA CORPORATION COMMISSION  
22 1200 West Washington Street  
Phoenix, Arizona 85007

23 AND copies of the foregoing mailed, hand-delivered,  
24 faxed or transmitted electronically this 18<sup>th</sup> day of  
July, 2007 to:

25 Janet Wagner  
26 Legal Division  
27 ARIZONA CORPORATION COMMISSION  
28 1200 West Washington  
Phoenix, Arizona 85007-2996

1 Ernest G. Johnson  
2 Director, Utilities Division  
3 ARIZONA CORPORATION COMMISSION  
4 1200 West Washington  
5 Phoenix, Arizona 85007-2996

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8 Donna Turner  
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# Exhibit 1

## Verified Application

# ORIGINAL NEW APPLICATION

BEFORE THE ARIZONA CORPORATION

## COMMISSIONERS

JEFF HATCH-MILLER, Chairman  
WILLIAM A. MUNDELL  
MIKE GLEASON  
KRISTIN K. MAYES  
BARRY WONG

E-01345A-06-0779

IN THE MATTER OF THE APPLICATION  
OF ARIZONA PUBLIC SERVICE  
COMPANY FOR AN ORDER OR  
ORDERS AUTHORIZING IT TO ISSUE,  
INCUR, AND AMEND EVIDENCES OF  
LONG-TERM INDEBTEDNESS AND  
SHORT-TERM INDEBTEDNESS, TO  
EXECUTE NEW SECURITY  
INSTRUMENTS TO SECURE ANY SUCH  
INDEBTEDNESS, TO REPAY AMOUNTS  
PAID UNDER ANY PINNACLE WEST  
CAPITAL CORPORATION GUARANTEE  
OF ARIZONA PUBLIC SERVICE  
COMPANY INDEBTEDNESS AND FOR  
DECLARATORY ORDER

IN THE MATTER OF THE APPLICATION  
OF PINNACLE WEST CAPITAL  
CORPORATION FOR AN ORDER OR  
ORDERS AUTHORIZING IT TO  
GUARANTEE THE INDEBTEDNESS OF  
ARIZONA PUBLIC SERVICE COMPANY

DOCKET NO. E-01345A-06-

VERIFIED APPLICATION

Arizona Corporation Commission  
**DOCKETED**

DEC 15 2006

DOCKETED BY

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## I. VERIFIED APPLICATION

Pursuant to Sections 40-285, 40-301, and 40-302 of the Arizona Revised Statutes ("A.R.S."), Arizona Public Service Company (the "Company") hereby files this Application seeking one or more orders which, together, will authorize the Company to:

(i) incur the Continuing Long-Term Debt (as defined herein); (ii) redeem, refinance, refund, renew, reissue, roll-over, repay, and re-borrow from time to time such Continuing Long-Term Debt, and establish and amend the terms and provisions of Continuing Long-Term Debt from time to time; (iii) incur the Continuing Short-Term Debt (as defined herein); (iv) redeem, refinance, refund, renew, reissue, roll-over, repay, and re-borrow from time to time such Continuing Short-Term Debt, and establish and amend the terms

1 and provisions of Continuing Short-Term Debt from time to time; (v) determine the form  
2 of security, if any, for the Continuing Long-Term Debt and the Continuing Short-Term  
3 Debt, execute and deliver one or more Security Instruments (as defined herein) in  
4 connection with the Continuing Long-Term Debt and the Continuing Short-Term Debt,  
5 and establish and amend the terms and provisions of any such Security Instruments from  
6 time to time; and (vi) reimburse any amounts paid by Pinnacle West Capital Corporation  
7 ("Pinnacle West") under any Guarantee (as defined herein).

8 APS further requests a declaratory order that confirms that only traditional  
9 indebtedness for borrowed money (and not the other types of arrangements described in  
10 paragraph 13 of this Application) constitutes an "evidence of indebtedness" under A.R.S.  
11 Sections 301 and 302 and that, therefore, such other arrangements (of the type described  
12 in paragraph 13) neither require prior Commission authorization nor count against the  
13 Continuing Long-Term Debt or Continuing Short-Term Debt authorizations requested in  
14 this Application.

15 Pursuant to A.A.C. R14-2-806, Pinnacle West hereby files this Application seeking  
16 an ongoing waiver of or authorization under A.A.C. R14-2-803 to allow Pinnacle West to  
17 guarantee the indebtedness of the Company from time to time.

18 APS and Pinnacle West request issuance of the order or orders sought in this  
19 Application no later than June 30, 2007 so that APS will have sufficient financing  
20 authority to support its obligations without interruption. APS and Pinnacle West also  
21 request that the order or orders sought in this Application become effective immediately  
22 upon the issuance thereof.

## 23 II. SUPPORTING STATEMENTS

24 In support of this Application, the Company and Pinnacle West respectfully state  
25 as follows:

26 1. Both the Company and Pinnacle West are corporations duly organized and  
27 existing under the laws of the State of Arizona. Their principal place of business is 400  
28

1 North Fifth Street, Phoenix, Arizona, 85004, and their post office address is P.O. Box  
2 53999, Phoenix, Arizona 85072-3999.

3 2. The Company is a public service corporation principally engaged in serving  
4 electricity in the State of Arizona.

5 3. The Company is a wholly-owned subsidiary of Pinnacle West.

6 4. On October 18, 2006, each of the Company's and Pinnacle West's Board of  
7 Directors approved the filing of this Application with the Commission.

8 5. The attorney for the Company in this proceeding is Thomas L. Mumaw.  
9 The attorney for Pinnacle West in this proceeding Robert J. Metli of Snell & Wilmer LLP.

10 6. This Application is supported by the Affidavit of Barbara M. Gomez, the  
11 Vice President and Treasurer of both the Company and Pinnacle West (the "Affidavit"),  
12 which is attached hereto as Exhibit A.

13 **Financing Needs and Issues**

14 7. The Commission's Decision No. 55017, dated May 6, 1986 (the "1986  
15 Order"), allows the Company, among other things, to have, at any one time outstanding in  
16 1986 or thereafter, long-term indebtedness (including current maturities thereof) in an  
17 aggregate principal amount of up to \$2,698,917,000. Such authorization also permits any  
18 redemptions, refinancings, refundings, renewals, reissuances, and roll-overs of any such  
19 outstanding indebtedness, the incurrence or issuance of any long-term indebtedness, and  
20 the amendment or revision of any terms or provisions of or relating to any long-term  
21 indebtedness, as long as total long-term indebtedness at any one time outstanding does not  
22 exceed \$2,698,917,000 during any period of more than thirty days. The 1986 Order  
23 specifies that the nature and terms of all such issuances and sales of such long-term  
24 indebtedness may be determined by the Company by reference to conditions in the  
25 financial markets at the time or times of such issuances. A copy of the 1986 Order is  
26 attached to this Application as Exhibit B.

27 8. In Commission Decision No. 65796, dated April 4, 2003 (the "2003  
28 Financing Order"), the Commission authorized the Company to issue \$500 million of

1 long-term debt and to loan the proceeds thereof to Pinnacle West or Pinnacle West Energy  
2 Corporation ("PWEC") for the purpose of repaying Pinnacle West debt incurred to  
3 finance construction of the Arizona electric generating plants built to serve APS native  
4 load and owned by PWEC and that were later transferred to the Company. In May of  
5 2003, the Company issued \$300 million of its 4.650% Notes due 2015 and \$200 million  
6 of its 5.625% Notes due 2033 (the "2003 Financing Order Debt")<sup>1</sup>. The 2003 Financing  
7 Order specified that the 2003 Financing Order Debt would not be counted against the then  
8 existing continuing debt limits authorized by the Commission in the 1986 Order. The  
9 increased amount requested for the Continuing Long-Term Debt limit in this Application  
10 includes the 2003 Financing Order Debt. The 1986 Order and the 2003 Financing Order  
11 are referred to herein as the "Orders." The Affidavit describes the benefits to the  
12 Company and its customers that have derived from the Orders during the twenty years  
13 since the 1986 Order was issued. See "Benefits of Historical Financial Flexibility" in the  
14 Affidavit.

15 9. In view of the growth of the Company and its customer base during the 20  
16 year period following the issuance of the 1986 Order, as well as changes in financial  
17 market conditions, the Company requests Commission authorization to increase the long-  
18 term indebtedness limitation set forth in the 1986 Order, so that the Company may have,  
19 at any one time outstanding from the date of such authorization or thereafter, up to an  
20 aggregate principal amount of long-term indebtedness of \$4.2 billion. The Affidavit  
21 describes the Company's outstanding long-term indebtedness, the reasons for its request  
22 for additional financing authority, and the basis of the requested increase. See "APS'  
23 Long-Term Debt Financing Needs" in the Affidavit. The Company requests that such  
24 authorization permit any redemptions, refinancings, refundings, renewals, reissuances,  
25 roll-overs, repayments, and re-borrowings of any such outstanding indebtedness, the  
26 incurrence or issuance of any additional long-term indebtedness, and the establishment,

27  
28 <sup>1</sup> Although the loan from APS to PWEC has subsequently been repaid in full, the above APS debt issuances remain outstanding.



1 amendment, or revision of any terms or provisions of or relating to any long-term  
2 indebtedness, as long as total long-term indebtedness (including current maturities  
3 thereof) at any one time outstanding does not exceed \$4.2 billion for any period of more  
4 than thirty days. Such authorization will allow the Company to maintain its flexibility to  
5 refund and/or incur or issue long-term indebtedness as market conditions dictate. At no  
6 time, however, will the Company be able to exceed the proposed long-term indebtedness  
7 limitation for any period of more than thirty days without further Commission  
8 authorization. (All long-term indebtedness outstanding on the date of the order or orders  
9 of the Commission in this matter or thereafter issued or incurred pursuant to this  
10 paragraph being herein referred to as "Continuing Long-Term Debt.") The authorization  
11 sought in this paragraph 9 would supersede the long-term indebtedness limitation  
12 authorized by the 1986 Order and would be inclusive of the debt issued pursuant to the  
13 2003 Financing Order.

14 10. A.R.S. Section 40-302.D allows the Company to issue short-term debt in an  
15 amount not to exceed 7% of its capitalization without Commission approval. However,  
16 Section 40-302.D restricts the refunding or roll-over of any such notes. The  
17 Commission's Decision No. 54230, dated November 8, 1984 (the "1984 Order"), allows  
18 the Company to reissue, renew, and resell any such short-term indebtedness and to refund,  
19 refinance, and roll-over any such short-term indebtedness with or into additional short-  
20 term indebtedness, as long as such 7% limit is not exceeded. The Company requests  
21 authority to issue short-term debt at any time and from time to time (excluding current  
22 maturities of long-term debt) in an amount not to exceed the sum of: (i) 7% of the  
23 Company's capitalization and (ii) \$500 million. The Affidavit describes the Company's  
24 outstanding short-term indebtedness, the reason for its request for additional short-term  
25 financing authority, and the basis of the requested increase. See "APS' Short-Term Debt  
26 Financing Needs" in the Affidavit. The Company requests that such authorization permit  
27 any redemptions, refinancings, refundings, renewals, reissuances, roll-overs, repayments,  
28 and re-borrowings of any such outstanding indebtedness, the incurrence or issuance of any

1 additional short-term indebtedness, and the establishment, amendment, or revision of any  
2 terms or provisions of or relating to any short-term indebtedness, as long as total short-  
3 term indebtedness at any one time outstanding (excluding current maturity of long-term  
4 debt) does not exceed, for any period of more than thirty days, the sum of: (i) 7% of the  
5 Company's capitalization and (ii) \$500 million without further Commission authorization.  
6 (All short-term indebtedness outstanding on the date of the order or orders of the  
7 Commission in this matter or thereafter issued or incurred pursuant to this paragraph  
8 being herein referred to as "Continuing Short-Term Debt.")

9 11. The Company proposes to determine the nature of the Continuing Long-  
10 Term Debt and Continuing Short-Term Debt (or the individual components of each  
11 issuance of Continuing Long-Term Debt or Continuing Short-Term Debt), the maturities  
12 thereof, the interest and/or discount rates thereon, the necessity for and form of any  
13 security therefor, the applicable financial markets (e.g., whether domestic or foreign) or  
14 lenders, the nature (e.g., whether public or private) of the offerings or borrowings, and the  
15 type or types of transaction in which debt would be sold or incurred by reference to  
16 conditions in the financial markets at the time or times of commitment or sale. Terms  
17 would be negotiated with the intent of obtaining the most favorable results for the  
18 Company and its customers. The security, if any, for any such debt by the Company  
19 could consist of a mortgage or other lien as discussed in paragraph 12 below or a letter of  
20 credit of a third party, bond purchase agreement, or other security instrument.

21 12. In the event that the rating on the Company's long-term unsecured  
22 indebtedness is rated non-investment grade or if market conditions otherwise dictate, the  
23 Company may find it necessary or advantageous to secure all or any portion of the  
24 Continuing Long-Term Debt and the Continuing Short-Term Debt. The Company  
25 requests authority to enter into a new mortgage and deed of trust or similar instrument that  
26 establishes a lien on all or substantially all of the Company's property, including after-  
27 acquired property, as security for all or any part of the Company's indebtedness. The  
28 Company also requests authority to enter into separate security instruments of various

1 types that establish liens on separate properties or groups of properties of the Company to  
2 secure particular issues or groups of issues of indebtedness. (Any such mortgage and  
3 deed of trust or other security instrument to be entered into pursuant to this paragraph  
4 being herein referred to as a "Security Instrument.") Any such Security Instrument may  
5 be used to secure indebtedness previously issued as well as new indebtedness issued after  
6 the date of the financing order requested by this Application. The Affidavit describes the  
7 mortgage and deed of trust previously utilized by the Company and its termination in  
8 2004, and further describes the basis and rationale for the requests in this paragraph 12.  
9 See paragraphs 13 and 22 in the Affidavit.

10 13. The Affidavit describes recent changes in accounting rules and  
11 interpretations that have altered and may continue to alter the basis for treatment of  
12 various financial arrangements as indebtedness. For example, the Affidavit describes  
13 certain circumstances in which a long-term power purchase agreement, long-term fuel  
14 supply contract, or similar agreements may be treated as a capital lease or a substantive  
15 consolidation and thus be treated as indebtedness on the Company's balance sheet under  
16 Generally Accepted Accounting Principles. The Company requests that the Commission  
17 confirm that only traditional indebtedness for borrowed money (and not the types of  
18 arrangements described in the preceding sentence) is subject to A.R.S. Sections 301 and  
19 302 and that, therefore, such other arrangements will not require prior Commission  
20 authorization or count against the Continuing Long-Term Debt authorization requested in  
21 this Application. The Affidavit further describes the basis and rationale for APS' requests  
22 in this paragraph 13. See paragraph 21 in the Affidavit.

23 14. From time to time, it may be advantageous for Pinnacle West to guarantee  
24 debt issued, incurred, or sold by the Company. Pinnacle West requests either an ongoing  
25 waiver of A.A.C. Rule 14-2-803 in that respect or, alternatively, that the Commission  
26 expressly grant to Pinnacle West authority to guarantee the Company's debt from time to  
27 time in indeterminate amounts (the "Guarantees"). The Company also seeks authorization  
28 to reimburse Pinnacle West for any amounts that Pinnacle West is required to pay under

1 any such Guarantee, along with interest on such amounts until the date of reimbursement  
2 at a rate not greater than the rate of interest payable on the debt so Guaranteed and paid by  
3 Pinnacle West. The Affidavit describes certain of the circumstances in which such a  
4 Guarantee may be required or advantageous and further describes the basis and rationale  
5 for the requests in this paragraph 14. See paragraph 23 in the Affidavit.

#### 6 Purposes

7 15. The Company proposes that the net proceeds from its issuance of  
8 Continuing Long-Term Debt and Continuing Short-Term Debt will be applied, directly or  
9 indirectly, to augment the funds available from all sources to finance its construction,  
10 resource acquisition and maintenance programs, to redeem or retire outstanding securities,  
11 to repay or refund other outstanding long-term or short-term debt, and to meet certain of  
12 the Company's working capital and other cash requirements.

13 16. The purpose of any Guarantees of Company debt by Pinnacle West would  
14 be to allow the Company to achieve greater access to the financial markets.

#### 15 General

16 17. In the Company's opinion, the proposed issuance or incurrence of the  
17 Continuing Long-Term Debt and the Continuing Short-Term Debt, the establishment and  
18 amendment of any terms and provisions of any long-term or short-term indebtedness, the  
19 execution and delivery of the Security Instruments, and the establishment and amendment  
20 of any terms and provisions of the Security Instruments, all as contemplated herein, are  
21 for lawful purposes that are within its corporate powers and are compatible with the public  
22 interest, with sound financial practices, and with the proper performance by the Company  
23 of service as a public service corporation and will not impair its ability to perform that  
24 service. The Company is further of the opinion that the foregoing, all as contemplated  
25 herein, are reasonably necessary or appropriate for such purposes and that such purposes  
26 are not, wholly or in part, reasonably chargeable to the Company's operating expenses or  
27 to income, except to the extent required by generally accepted accounting principles or by  
28 other accounting requirements applicable to the Company, including regulatory

1 requirements. To the extent that the purposes set forth herein may be considered  
2 reasonably chargeable to operating expenses or to income, the Company requests that the  
3 order or orders of the Commission in this matter authorize such charge or charges.

4 18. A.A.C. R14-2-803 requires notice to the Commission of "reorganizations"  
5 by a public utility holding company such as Pinnacle West. A "reorganization" includes  
6 the "acquisition or divestiture of a financial interest in an affiliate or a [Class A] utility."  
7 A.A.C. R14-2-801(5). The Company is a Class A utility, and thus both it and Pinnacle  
8 West are subject to the provisions of Rule 803. In Decision No. 58063, dated November  
9 3, 1992, the Commission interpreted the aforementioned language to also include any  
10 increase or decrease of an existing "financial interest" in a utility in excess of a specified  
11 "exempt amount," which in the case of the Company and Pinnacle West, is \$100 million  
12 per year, even if the increase/decrease did not change the status of the utility as a wholly-  
13 owned subsidiary of the public utility holding company. The proposed Guarantees could  
14 result in an increase in Pinnacle West's existing financial interest in the Company in  
15 excess of \$100 million per year. The test for whether a "reorganization" can be rejected  
16 by the Commission under Rule 14-2 803 is whether the "reorganization" would: (1)  
17 impair the financial status of the public utility, (2) prevent the public utility from  
18 attracting capital on fair and reasonable terms, or (3) impair the ability of the public utility  
19 to provide safe, reasonable, and adequate service. The proposed Guarantees clearly will  
20 not have any of these negative impacts on the Company. Rather they will enhance the  
21 financial status of the Company, permit the Company to attract capital and access the  
22 capital markets on terms that are more favorable, and are essential to the Company's  
23 ability to provide safe, reasonable, and reliable service. The Company notes that pursuant  
24 to A.A.C. R14-2-806.C, if the Commission fails to approve, disapprove, or suspend for  
25 further consideration an application for waiver within thirty days following filing of a  
26 verified application for waiver, the waiver shall become effective on the 31st day  
27 following the filing of the application.

1           19.    The Company requests that notice of the filing of this Application be given  
2 in conformity with A.R.S. Section 40-302.

3           20.    The Company requests that the order or orders sought by this Application  
4 become effective immediately upon the issuance thereof.

5           21.    The most current public financial statements of the Company and Pinnacle  
6 West, which are included in their most recent combined Quarterly Report on Form 10-Q  
7 filed with the Securities Exchange Commission, are attached to this Application as  
8 Exhibit C.

9           WHEREFORE, the Company and Pinnacle West ask that the Commission cause  
10 notice of the filing of this Application to be given as above-requested; hold such a hearing  
11 or hearings as the Commission finds are necessary at a time or times to be specified,  
12 making such inquiry or investigation as the Commission may deem of assistance; and  
13 make any findings required by A.R.S. Sections 40-285, 40-301, and 40-302, or A.A.C.  
14 R14-2-803 and R14-2-806, as applicable, relative to the issuances and incurrences of  
15 Continuing Long-Term Debt and Continuing Short-Term Debt, the execution and delivery  
16 of the Security Instruments, the establishment and amendment of any terms and  
17 provisions of any long-term or short-term indebtedness or any such Security Instruments,  
18 the issuance of the Guarantees, and the reimbursement by the Company of amounts paid  
19 by Pinnacle West under the Guarantees, all as contemplated herein; and thereafter make  
20 one or more immediately effective orders which, together, (i) authorize the Company to  
21 issue, sell, and incur the Continuing Long-Term Debt and the Continuing Short-Term  
22 Debt, redeem, refinance, refund, renew, reissue, roll-over, repay, and re-borrow from time  
23 to time such Continuing Long-Term Debt and Continuing Short-Term Debt, and establish  
24 and amend the terms and provisions of long-term and short-term indebtedness from time  
25 to time, (ii) authorize the Company to determine the form of security, if any, for the  
26 Continuing Long-Term Debt and the Continuing Short-Term Debt, execute and deliver  
27 the Security Instruments, and establish and amend the terms and provisions of the Security  
28 Instruments, as may be deemed appropriate by the Company in connection with the

1 Continuing Long-Term Debt and the Continuing Short-Term Debt, (iii) state that the  
2 issuances and incurrences of the Continuing Long-Term Debt and the Continuing Short-  
3 Term Debt and the establishment and amendment of the terms and provisions of any  
4 outstanding long-term or short-term indebtedness are reasonably necessary or appropriate  
5 for the purposes set forth in this Application and that such purposes are within those  
6 permitted by A.R.S. Section 40-301, (iv) permit such purposes to the extent that they may  
7 be reasonably chargeable to operating expenses or to income, (v) authorize a continuing  
8 waiver of or authorization under R14-2-803 with respect to Pinnacle West Guarantees of  
9 Company indebtedness, (vi) authorize the Company to reimburse Pinnacle West for any  
10 payment on any such Guarantees, with interest as contemplated herein and (vii) confirm  
11 that only traditional indebtedness for borrowed money (and not the other types of  
12 arrangements described in paragraph 13 of this Application) are subject to A.R.S. Sections  
13 301 and 302 and that, therefore, such arrangements will not count against the Continuing  
14 Long-Term Debt or Continuing Short-Term Debt authorizations requested in this  
15 Application or require prior Commission approval.

16 Financing orders of the kind requested herein require very specific language to  
17 satisfy prospective lenders. Thus, proposed language for certain key paragraphs of the  
18 order requested in this matter is attached to this Application as Exhibit D.

19 Dated at Phoenix, Arizona this 15<sup>th</sup> day of December, 2006.

20 ARIZONA PUBLIC SERVICE COMPANY

21 By: Barbara M. Gomez  
22 Barbara M. Gomez  
23 Vice President and Treasurer

24 ATTEST:

25 Betsy Pregulman  
26 Betsy Pregulman  
27 Associate Secretary  
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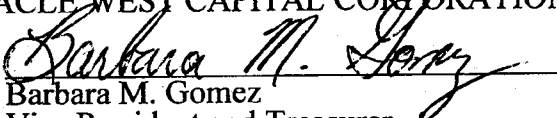
ATTORNEY FOR ARIZONA PUBLIC SERVICE  
COMPANY

By:

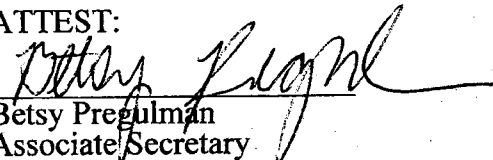
  
Thomas L. Mumaw  
Arizona Public Service Company

PINNACLE WEST CAPITAL CORPORATION

By:

  
Barbara M. Gomez  
Vice President and Treasurer

ATTEST:

  
Betsy Pregulman  
Associate Secretary

ATTORNEY FOR PINNACLE WEST CAPITAL  
CORPORATION

By:

  
Robert J. Metli  
Snell & Wilmer LLP



STATE OF ARIZONA                    )  
County of Maricopa                    )ss.

Barbara M. Gomez, being first duly sworn, deposes and says:

That she, Barbara M. Gomez, is the Vice President and Treasurer of Arizona Public Service Company; that she has read the foregoing Application and knows the contents thereof as it relates to Arizona Public Service Company; and that the same is true in substance and in fact, except as to matters therein stated on information and belief, and as to those she believes them to be true.

*Barbara M. Gomez*  
Barbara M. Gomez

SUBSCRIBED AND SWORN to before me this 15 day of December, 2006.

*Sandra S. Selman*  
Notary Public

**My commission expires:**





EXHIBITS

- Exhibit A Affidavit of Barbara M. Gomez, the Vice President and Treasurer of each of the Company and Pinnacle West.
- Exhibit B Arizona Corporation Commission Order in Decision No. 55017, dated May 6, 1986.
- Exhibit C Pinnacle West Capital Corporation and Arizona Public Service Company Quarterly Report on Form 10-Q for the quarter ended September 30, 2006.
- Exhibit D Certain Language for Proposed Order.

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EXHIBIT A

Affidavit

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, Chairman  
WILLIAM A. MUNDELL  
MIKE GLEASON  
KRISTIN K. MAYES  
BARRY WONG

IN THE MATTER OF THE APPLICATION  
OF ARIZONA PUBLIC SERVICE  
COMPANY FOR AN ORDER OR  
ORDERS AUTHORIZING IT TO ISSUE,  
INCUR, AND AMEND EVIDENCES OF  
LONG-TERM INDEBTEDNESS AND  
SHORT-TERM INDEBTEDNESS, TO  
EXECUTE NEW SECURITY  
INSTRUMENTS TO SECURE ANY SUCH  
INDEBTEDNESS, TO REPAY AMOUNTS  
PAID UNDER ANY PINNACLE WEST  
CAPITAL CORPORATION GUARANTEE  
OF ARIZONA PUBLIC SERVICE  
COMPANY INDEBTEDNESS AND FOR  
DECLARATORY ORDER

DOCKET NO. E-01345A-06-\_\_\_\_\_

**AFFIDAVIT OF  
BARBARA M. GOMEZ**

IN THE MATTER OF THE APPLICATION  
OF PINNACLE WEST CAPITAL  
CORPORATION FOR AN ORDER OR  
ORDERS AUTHORIZING IT TO  
GUARANTEE THE INDEBTEDNESS OF  
ARIZONA PUBLIC SERVICE COMPANY

STATE OF ARIZONA            )  
  )ss.  
County of Maricopa         )

I, Barbara M. Gomez, upon my oath, do swear and attest as follows:

**General**

1. My name is Barbara M. Gomez. I am Vice President and Treasurer for both Arizona Public Service Company ("APS" or "Company") and Pinnacle West Capital Corporation ("Pinnacle West"). I am responsible for the Treasury functions at APS and Pinnacle West.

2. The assertions of fact contained within the Verified Application of the Company to which this Affidavit is attached are true and correct to my knowledge and belief.

3. The purpose of this Affidavit is to testify, from my personal experience and involvement as the Treasurer, regarding the rationale behind the requests contained in the Application.

### Specific Background Facts

4. The Arizona Corporation Commission's ("Commission") Decision No. 55017, dated May 6, 1986 (the "1986 Order"), allows the Company to have outstanding at any one time long-term indebtedness (including current maturities) in an aggregate principal amount of \$2,698,917,000. The 1986 Order permits the Company to issue, redeem or refinance and establish and amend the terms of its long-term debt, as long as the total outstanding long-term debt does not exceed \$2,698,917,000 during any period of more than thirty days. The fact that the long-term debt limit can actually be exceeded for a period of thirty days or less enables APS to issue new long-term debt in advance of an upcoming planned redemption.

5. In Commission Decision No. 65796 dated April 4, 2003 (the "2003 Financing Order"), the Commission authorized the Company to issue \$500 million of long-term debt and to loan the proceeds to Pinnacle West or Pinnacle West Energy Corporation ("PWEC"). The purpose of the intercompany loan was to repay the Pinnacle West debt incurred to finance construction of the Arizona electric generating plants built to serve APS native load and owned by PWEC. In May of 2003, APS issued \$300 million of its 4.65% Notes due 2015 and \$200 million of its 5.625% Notes due 2033. The PWEC Arizona generation assets were later transferred to the Company, and the intercompany loan was repaid. The \$500 million of long-term debt that remains on APS' books today in effect financed the new generation assets. The 2003 Financing Order specified the \$500 million of debt that APS issued would not be counted against the continuing debt limits authorized by the Commission in the 1986 Order.

6. By means of the 1986 Order and the 2003 Financing Order the Commission has authorized APS to issue a total of \$3,198,917,000 of long-term debt. The Company is asking the Commission to increase the continuing long-term debt limit in its Application.

7. Arizona Revised Statutes §40-302.D allows the Company to issue short-term debt in an amount not to exceed 7% of its capitalization without Commission approval. However,

1 §40-302.D restricts the refunding or roll-over of any such notes. The Commission's Decision No.  
2 54230 dated November 8, 1984 (the "1984 Order") allows the Company to refund or roll-over  
3 any such short-term debt as long as the 7% limit is not exceeded.

#### 4 **Benefits of Historical Financial Flexibility**

5 8. The 1986 Order and 2003 Financing Order have provided significant financing  
6 flexibility that has served the Company's customers extremely well for, in the case of the 1986  
7 Order, the past 20 years. The Company accessed the frequently volatile capital markets in a  
8 timely and efficient manner, thereby reducing the Company's financing costs and the cost of  
9 capital reflected in customer rates.

10 9. During the period from 1985 to the present, the Company has issued nearly  
11 \$7 billion in long-term debt, taking advantage of troughs in the interest rate cycle and turning  
12 over the Company's entire debt capitalization about three times. As a result, average long-term  
13 debt costs have dropped from 10.5% in 1985 to 5.2% in 2005. See Attachment A for a graphical  
14 representation of the decline in APS' long-term debt costs. In 1992 alone, the Company  
15 voluntarily refinanced \$650 million of debt, producing total interest savings of some \$120 million  
16 over the then remaining life of the refinanced debt.

17 10. The concept of an overall limit on the amount of long-term debt outstanding, as  
18 contained in the 1986 Order, has provided APS financial flexibility to take advantage of optimal  
19 financial conditions at the time of each financing. This flexibility occurs in a number of areas.  
20 First, there is the ability to time the financing at the optimal point in terms of financial market  
21 conditions, SEC disclosure requirements, and cash flow requirements. Markets are volatile, and  
22 having the ability to quickly enter the markets to issue new debt yields better financing pricing  
23 and terms. Second, there is the ability to size the borrowing at the optimal level. Since APS  
24 knew it could enter the market as many times as necessary as long as it stayed within the limit, it  
25 could do smaller debt issuances if that were advantageous at the time. Third, there is the ability  
26 to obtain the best terms available at the time. Since the Company was given the ability to  
27 negotiate the terms deemed appropriate, it could adapt to changing market conditions and get the  
28 best terms available at the time of the financing.

1           11.     APS' long-term debt portfolio compares quite favorably with its peers. The most  
2 applicable index available for comparison purposes is the Lehman Brothers Electric Utility Index  
3 ("Index"), which is comprised of over 250 bonds issued by about 100 companies. The weighted  
4 average coupon of the Index at year-end 2005 was 6.10%, which exceeded APS' average coupon  
5 on its taxable debt of 5.86% by 24 basis points. APS was able to achieve a lower cost of long-  
6 term debt while having slightly longer dated bonds. APS has an average years to maturity on its  
7 taxable debt of 12.0 years, which is 0.5 years longer than the 11.5 year average life of the Index.

8           12.     The Company has also done an excellent job of managing its tax-exempt bond  
9 portfolio. APS has outstanding approximately \$656 million of tax-exempt debt, the proceeds of  
10 which financed pollution control equipment at its coal and nuclear power plants. In addition,  
11 APS has refinanced the tax-exempt bonds several times in order to obtain lower interest rates or  
12 more favorable credit enhancements. At December 31, 2005, the average cost of the tax-exempt  
13 debt was 3.25%, and the average life was 24 years. The financing flexibility of the 1986 Order  
14 has enabled APS to obtain this low cost form of financing, which results in a lower cost of capital  
15 reflected in customer rates.

16           13.     APS redeemed the last of its secured debt in April of 2004. Prior to that time APS  
17 had issued debt that was secured by substantially all of the property of APS pursuant to the 1946  
18 Mortgage and Deed of Trust. The 1946 Mortgage was almost 60 years old at the time of  
19 termination, and it did not reflect current market standards for utility secured bond indentures. It  
20 also contained certain restrictive covenants. By eliminating the 1946 Mortgage, APS has greater  
21 financial flexibility. However, there may come a time when it is advantageous for APS to enter  
22 into a new mortgage or other security agreements and once again issue secured debt.

23           14.     APS manages its debt portfolio with the goal of having an appropriate mix of fixed  
24 and floating rate instruments. The Board of Directors has established a Pinnacle West  
25 consolidated limit on floating rate debt of 20% of capitalization. APS had 10.2% floating rate  
26 debt at December 31, 2005. Most of the floating rate debt is in the tax-exempt instruments, which  
27 have less volatility of interest rates than taxable debt. This is another example of how the 1986  
28



1 Order has enabled the Company to manage its debt portfolio so as to benefit the Company and its  
2 customers.

3 15. A.R.S. Section 40-302.D and the 1984 Order enable the Company to issue short-  
4 term debt up to 7% of capitalization. APS meets its seasonal working capital requirements with  
5 short-term borrowings, often in the form of commercial paper. Since the statutory limit is a  
6 percent of capitalization, as the Company has grown in size and its capital structure has increased,  
7 the amount of short-term debt capacity has also increased. This has provided APS the flexibility  
8 to continue to meet its growing working capital needs.

9 16. The Company has continuously complied with each of the terms and conditions of  
10 the 1986 Order and the 2003 Financing Order and is in compliance with such Orders as of the  
11 date of this Application.

12 17. The Company has operated under the 1986 Order and the 2003 Financing Order in  
13 a manner that is compatible with sound financial policy and the public interest. By having ready  
14 access to the capital markets as well as the ability to refinance existing debt when the opportunity  
15 arises, the Company is able to reduce interest costs, which results in lower customer rates. The  
16 new financing authority requested in the Application would enable APS to continue to manage its  
17 debt requirements despite changing financial needs and conditions. Thus, the requested financing  
18 order is compatible with sound financial policy and the public interest.

#### 19 **APS' Long-Term Debt Financing Needs**

20 18. At September 30, 2006, the Company had total outstanding long-term debt  
21 (authorized under the 1986 Order and the 2003 Financing Order) in an aggregate principal  
22 amount of \$2,962,071,043. This amount includes current maturities of long-term debt. On  
23 November 15, 2006, APS had a bond maturing in the amount of \$83,695,000. At December 31,  
24 2006 the amount of long-term debt is expected to be approximately \$2.88 billion. As stated  
25 above, the 1986 Order and 2003 Financing Order collectively limit long-term debt to an aggregate  
26 principal amount of \$3,198,917,000. Comparing the expected year-end 2006 debt balance to the  
27 limit on long-term debt shows that APS would have authorization to issue approximately an  
28 additional \$300 million.

1           19. In light of the projected growth of the Company and its customer base, and the  
2 resultant projected future financing needed to fund the Company's capital expenditure and  
3 maintenance program and other cash requirements, the Company requests Commission  
4 authorization to increase the long-term debt limitation by approximately \$1 billion so that the  
5 Company may have up to an aggregate principal amount of long-term debt of \$4.2 billion. This  
6 amount would include the \$500 million currently authorized in the 2003 Financing Order. The  
7 additional \$1 billion is approximately three years of external financing requirements. See  
8 Attachment B for details on the derivation of the additional \$1 billion of long-term debt authority  
9 requested. Absent this higher continuing debt limit, APS' ability to access the debt capital  
10 markets in a timely manner to take advantage of favorable market conditions will be severely  
11 impacted. APS would be required to request Commission authorization for each debt issuance  
12 once the current limit is met and would need to seek authorization well in advance of each  
13 issuance to ensure the authorization was in place at the time the funding was required. In addition  
14 to hampering the Company's ability to advantageously and strategically access the debt capital  
15 markets, which could unnecessarily increase the Company's cost of capital, this would be  
16 administratively inefficient for both the Commission and the Company.

17           20. APS requests to continue the ability to determine the terms of any long-term debt  
18 issuances. Maturity, interest rate, discount and other factors would be negotiated in order to  
19 obtain the most favorable terms possible for the Company and its customers.

#### 20                           **Other Components of Long-Term Debt Authorization**

21           21. The Company also seeks to confirm that the new continuing debt limit applies only  
22 to debt for borrowed money. As a result of changes in accounting principles and interpretations,  
23 there could be instances in which other types of financial obligations may be classified as debt in  
24 the Company's financial statements in order to be in compliance with Generally Accepted  
25 Accounting Principles. For example, there are currently issues regarding the accounting for long-  
26 term power purchase agreements. Depending on the length and nature of the agreement, such  
27 arrangements may be classified as capital leases and reflected as debt on the balance sheet of the  
28 Company. Similar issues could apply to other contracts, such as long-term fuel supply contracts.

1 This could potentially erode the debt-issuing capability of APS and greatly affects the ability of  
2 the Company to plan its normal financing activities if these arrangements are included in the  
3 continuing debt limit or require prior authorization. By finding that such arrangements are not  
4 subject to A.R.S. Sections 301, et seq., the new continuing debt limits will then only apply to  
5 traditional borrowings, and the Company will not be at the mercy of changes in accounting  
6 regulations.

7 22. In the future APS may find it necessary or advantageous to secure its debt with the  
8 property of the Company. APS' credit ratings are currently just one notch above non-investment  
9 grade. If APS' credit rating were to fall to non-investment grade, its access to the debt capital  
10 markets would be severely curtailed. Even if APS were able to locate non-investment grade  
11 investors, there would likely be much more restrictive covenant requirements. These restrictions  
12 could include limitations on the use of proceeds, draconian financial tests, and restrictions on free  
13 cash flow. In such an environment, APS may be required to issue secured debt in order to obtain  
14 the necessary financing. In addition, there may be an interest rate or financial market  
15 environment in which it is advantageous for APS to issue secured debt. While the 1986 Order  
16 allowed APS to use its assets to secure debt, this authorization was granted under the 1946  
17 Mortgage, which has since been retired. Therefore, APS is also requesting Commission  
18 authorization to pledge or mortgage APS assets as security for its debt. This would include  
19 authority to enter into a new mortgage and deed of trust that establishes a lien on all or  
20 substantially all of the Company's property, as well as the authority to enter into separate security  
21 instruments for one or more particular debt issuances.

22 23. It may be advantageous for Pinnacle West to guarantee APS debt issuances. APS'  
23 debt is currently registered with the Securities and Exchange Commission ("SEC") under the  
24 recently enacted short-form registration forms and procedures. In the event the Company is not  
25 rated investment grade by at least one nationally recognized statistical rating organization at the  
26 time of a debt issuance, a Pinnacle West guarantee would be necessary under the SEC rules to  
27 allow continued utilization of these short-form registration forms and procedures. With a parental  
28 guarantee, the Company would have greater access to the public financial markets. Pinnacle

1 West requests a waiver of or authority under A.A.C. R14-2-803 to guarantee the Company's debt  
2 as needed from time to time. The Company also seeks authorization to reimburse Pinnacle West  
3 for any amounts that Pinnacle West is required to pay under any such guarantee, along with  
4 associated interest.

#### 5 **APS' Short-Term Debt Financing Needs**

6 24. In addition to an increase in the long-term debt limit, the Company also requests  
7 an increase in the short-term debt limit. A.R.S. § 40-302.D allows the Company to issue short-  
8 term debt in an amount not to exceed 7% of its capitalization without Commission approval. The  
9 1984 Order allows the Company to refinance and roll-over short-term debt as long as the 7% limit  
10 is not exceeded. APS is required to obtain approval from the Commission to exceed the limit.  
11 Based on its current capitalization, APS' short-term debt is limited to approximately \$420  
12 million. As of September 30, 2006, APS had no short-term debt outstanding.

13 25. As APS continues to grow, so does its need for working capital. The 7% limit has  
14 adequately met the seasonal working capital requirements of the utility for many years. However,  
15 APS' load growth has resulted in an increased exposure to contracted commodity and purchased  
16 power. These contracts have cash collateral provisions that can result in significant liquidity  
17 demands on the Company as market prices change. APS has recently experienced changes in  
18 cash collateral positions in the magnitude of \$100 million in just several days. If APS were to  
19 become a non-investment grade company, the magnitude of the collateral changes would be even  
20 more extreme since counterparties require additional collateral depending on credit quality. The  
21 increased liquidity required to respond to volatile and increasing collateral requirements has  
22 resulted in the need for short-term debt in excess of the currently authorized amount.

23 26. The Company recently completed an assessment of its liquidity needs and  
24 determined that an additional \$500 million was necessary. In September of 2006, APS closed a  
25 \$500 million revolving credit facility which was syndicated in the bank markets primarily with its  
26 existing group of lenders. This facility is in addition to the \$400 million revolving credit facility  
27 that is used for normal working capital requirements. In order to fully utilize the short-term debt  
28 capability provided by the new revolver, additional Commission authority is required.

27. If the short-term debt limit is not increased, APS would have to issue long-term debt to fund its short-term needs. This is an uneconomic solution and does not follow the financial principle of financing short-term needs with short-term debt.

28. Based on the recent analysis of liquidity needs, including working capital and potential collateral calls, the Company has determined that an additional \$500 million of short-term debt authorization would be adequate. The Company is requesting the short-term debt limit be increased to the sum of 7% of capitalization and \$500 million, and that the Commission order continue to allow the refinancing and roll-over of such short-term debt.

29. APS requests to continue the ability to determine the terms of any short-debt issuances and to secure any such indebtedness if necessary or advantageous. Maturity, interest rate, discount and other factors would be negotiated in order to obtain the most favorable terms possible for the Company and its customers.

## Summary

30. The financing flexibility provided in previous Commission orders has served the Company's customers extremely well by allowing the Company to access frequently volatile capital markets in a timely and efficient manner, thereby reducing the Company's financing costs and the cost of capital reflected in customer rates. APS faces a growing customer base requiring significant capital expenditures that will necessitate additional long-term debt financing. Additional short-term debt capacity is also required for growing liquidity needs. The Company is seeking a new financing order that authorizes the higher long- and short-term debt limits and other requested components. This new financing order would allow APS to continue to meet the growing financing needs in an efficient and cost effective manner that benefits APS' customers.


Dated this 15<sup>th</sup> day of December, 2006.

FURTHER AFFIANT SAYETH NOT.

DT. Barbara M. Gomez  
Barbara M. Gomez

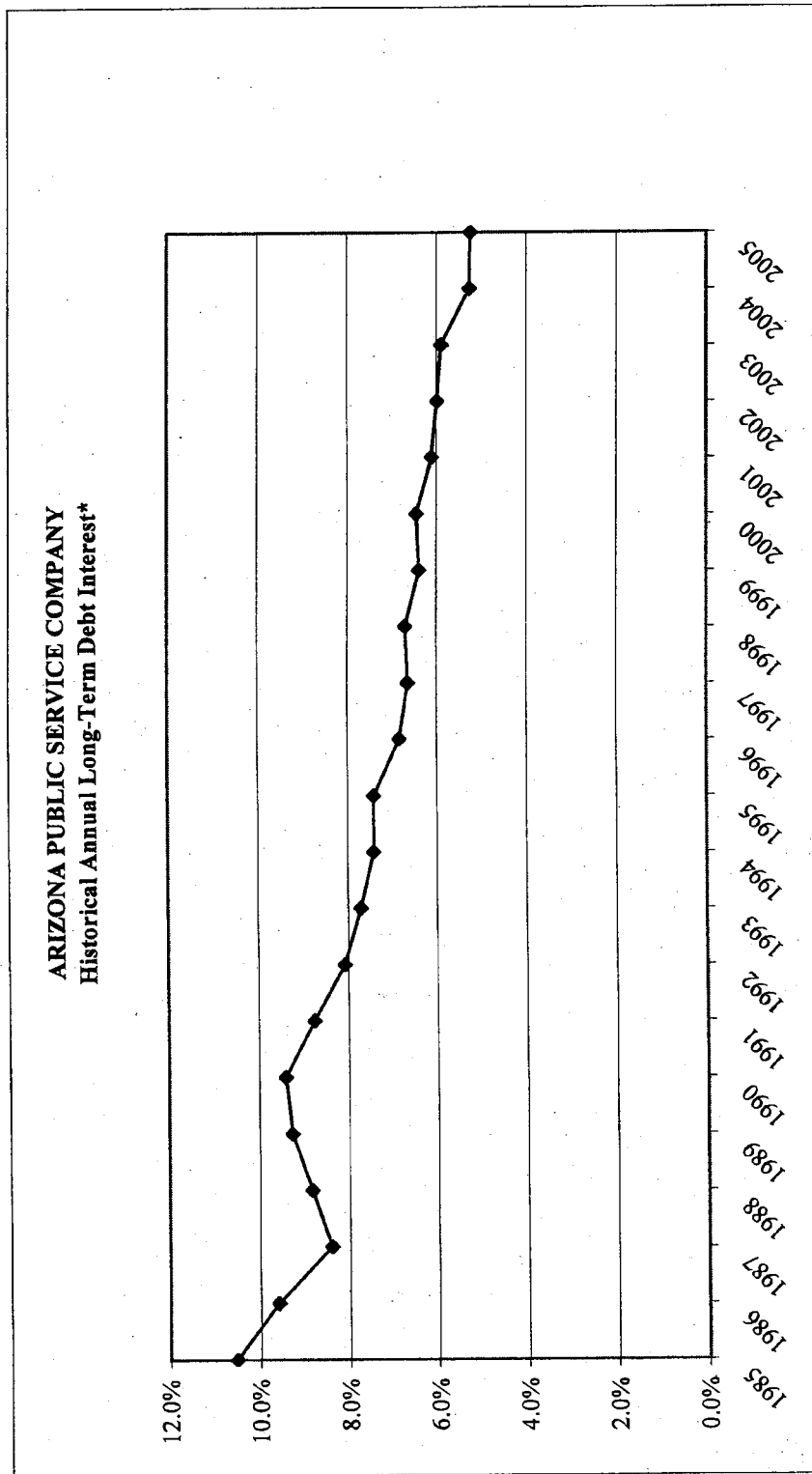
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SUBSCRIBED AND SWORN TO BEFORE ME this 15<sup>th</sup> day of December, 2006, by  
Barbara M. Gomez, Vice President and Treasurer of Arizona Public Service Company and  
Pinnacle West Capital Corporation

  
Notary Public

MY COMMISSION EXPIRES:





\* Calculated as Interest Expense before Capitalized Interest (Income Statement) divided by two-point average Long-Term Debt including Current Maturities (Balance Sheet).

**Arizona Public Service**  
**Financing Requirements 2007 - 2009**  
**(\$Millions)**

Line #		2007	2008	2009 (same as 2008)	Total
1	Net Income	\$ 263	\$ 267	\$ 267	\$ 797
2	Depreciation and Amortization	376	395	395	1,166
3	Nuclear Fuel	41	43	43	127
4	Deferred Tax	(30)	(35)	(35)	(100)
5	Deferred Fuel	76	53	53	182
6	Interest on Deferred Fuel	(9)	(4)	(4)	(17)
7	AFUDC Debt/Capitalized Interest	(9)	(10)	(10)	(29)
8	AFUDC Equity	(13)	(15)	(15)	(43)
9	Funds from Operations	695	694	694	2,083
10	Common Dividends	(170)	(200)	(200)	(570)
11	Net Cash Flow	525	494	494	1,513
12	Construction Expenditures	895	924	924	2,743
13	Capitalized Property Taxes	6	6	6	18
14	Capital Expenditures	901	930	930	2,761
15	Additional Financing Requirements	\$ 376	\$ 436	\$ 436	\$ 1,248

Note: 2007 and 2008 projections included in rebuttal in amended 2005 general rate case. Imputed depreciation has been removed from the typical rating agency calculation of FFO to provide a more realistic estimate of financing needs.



EXHIBIT B

Arizona Corporation Commission Order in Decision No. 55017,  
dated May 6, 1986

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DOCKETED

MAY 06 1986

## BEFORE THE ARIZONA CORPORATION COMMISSION

1 RENZ D. JENNINGS  
2 CHAIRMAN  
3 MARCIA WEEKS  
4 COMMISSIONER  
5 SHARON B. MEGDAL  
6 COMMISSIONER

DOCKETED BY

C. M.

7 IN THE MATTER OF THE APPLICATION )  
8 OF ARIZONA PUBLIC SERVICE COMPANY )  
9 FOR AN ORDER OR ORDERS AUTHORIZING IT )  
10 TO ISSUE, INCUR AND AMEND EVIDENCES OF )  
11 LONG-TERM INDEBTEDNESS, TO ISSUE OR )  
12 INCUR NUCLEAR FUEL DEBT, AND TO )  
13 EXECUTE A NEW SUPPLEMENTAL INDENTURE OR )  
14 INDENTURES. )

DOCKET NO. U-1345-86-003

DECISION NO. 55017ORDER

15 Open Meeting  
16 April 30, 1986  
17 Phoenix, Arizona

BY THE COMMISSION:

18 On December 31, 1985, Arizona Public Service Company ("APS") filed an  
19 Application with the Arizona Corporation Commission ("Commission") wherein APS  
20 sought authorization to, among other things, implement various financings.

21 On February 25, 1986, the Residential Utility Consumer Office ("RUICO")  
22 filed an Application to Intervene herein. Said Application was granted by  
23 Procedural Order dated March 4, 1986.

24 On April 17, 1986, the Commission's Utilities Division Staff ("Staff")  
25 filed a Memorandum recommending approval without hearing of the proposed  
26 financing program. Attached thereto was written testimony by a Staff Senior  
27 Rate Analyst, which testimony supported Staff's overall recommendation.

28 \* \* \* \* \*

29 Having considered the Application, the exhibits and draft testimony  
30 submitted therewith, as well as Staff's memorandum and attached testimony, and  
31 being fully advised in the premises, the Commission finds, concludes and orders  
32 that:

FINDINGS OF FACT

1           1.    APS is an Arizona corporation engaged in providing electric service  
2 to the public within portions of Arizona pursuant to authority granted by this  
3 Commission.  
4

5           2.    By its Application, as supplemented by APS's draft testimony in this  
6 matter, APS requests one or more orders seeking the following:

7           (a)   authorization to issue, sell, and incur in 1986  
8                or pursuant to lending, purchase, or underwriting  
9                commitments obtained in 1986, in one or more  
10              transactions, up to \$275,000,000 in aggregate  
11              principal amount of additional evidences of long-term  
12              indebtedness (all such evidences of indebtedness  
13              hereinafter being referred to as "New Debt"),  
14              it being specified that the nature and terms of all  
15              such issuances and sales of New Debt would be determined  
16              by APS by reference to conditions in the financial  
17              markets at the time or times of commitment;

18           (b)   authorization to increase the long-term indebtedness  
19                limitation authorized in the Commission's Order in  
20                Decision No. 54230, dated November 8, 1984, that allowed  
21                APS, among other things, to have, at any one time  
22                outstanding in 1985 or thereafter, long-term indebtedness  
23                (including current maturities thereof) in an aggregate  
24                principal amount of \$2,374,093,000, so as to allow  
25                APS to have, at any one time outstanding, up to an  
26                aggregate principal amount of long-term indebtedness  
27                (including current maturities thereof) of \$2,698,917,000,  
28                such authorization to permit any redemptions, refinancings,

1 refundings, renewals, reissuances and roll-overs of any  
2 such outstanding indebtedness, the incurrence or  
3 issuance of any additional long-term indebtedness, and the  
4 amendment or revision of any terms of provisions of or  
5 relating to any long-term indebtedness, as long as  
6 total long-term indebtedness at any one time outstanding  
7 does not exceed (without further Commission authorization)  
8 \$2,698,917,000 during any period of more than thirty days,  
9 it being specified that the nature and terms of all such  
10 issuances and sales of such long-term indebtedness  
11 would be determined by APS by reference to conditions  
12 in the financial markets at the time or times of such  
13 issuances (all such long-term indebtedness to be issued  
14 pursuant to this authorization being herein referred to  
15 as "Continuing Debt"), and such authorization to  
16 supercede the long-term indebtedness limitation  
17 authorized by Decision No. 54230.

18 (c) authorization in connection with providing security  
19 for any New Debt or Continuing Debt, to execute and  
20 deliver one or more new supplemental indentures to its  
21 Mortgage and Deed of Trust in the event it is  
22 deemed appropriate by APS to do so;

23 (d) authorization for APS to finance its nuclear fuel  
24 requirements in connection with the operation of  
25 the Palo Verde Nuclear Generating Station by  
26 instituting a financing program involving the issuance  
27 of APS of commercial paper, intermediate-term notes,  
28

1 and/or other evidences of indebtedness in an aggregate  
2 principal amount of up to \$200,000,000, all of which  
3 may constitute long-term debt (collectively, the  
4 "Nuclear Fuel Debt"), and in connection therewith, to  
5 issue or incur evidences of indebtedness in 1986 or  
6 thereafter, and to refund or roll-over all or a portion  
7 of the Nuclear Fuel Debt, any short-term debt to be issued  
8 in connection therewith to be in addition to short-term  
9 debt previously authorized by the Commission or per-  
10 mitted by A.R.S. Section 40-302.D, it being specified  
11 that the nature and terms of any issuances and sales  
12 of Nuclear Fuel Debt would be determined by APS by  
13 reference to conditions in the financial markets at the  
14 time or times of commitment.

15 3. On April 17, 1986, Staff filed a Memorandum and written testimony  
16 supporting the Application and recommending summary approval thereof.

17 4. The New Debt and the Continuing Debt will be utilized for APS's  
18 construction program, the refinancing, retirement, or redemption of outstanding  
19 securities, the repayment of short-term debt which previously financed  
20 construction projects, and, if necessary, the payment of certain of APS's  
21 working capital and other cash requirements. The Nuclear Fuel Debt will be  
22 used to finance APS's nuclear fuel requirements for the Palo Verde Nuclear  
23 Generating Station, and/or to refund or roll-over the Nuclear Fuel Debt.

24 5. The costs of nuclear fuel will be charged to operating expense or  
25 income as such fuel is consumed.

26 6. The Nuclear Fuel Debt would not exceed \$200,000,000 through a  
27 combination of intermediate-term domestically issued debt (not to exceed  
28 \$50,000,000), a European commercial paper program, and a short-term European

1 loan facility. The Nuclear Fuel Debt may exceed APS's net nuclear fuel assets  
2 (up to the \$200,000,000 limit).

3 7. The exact timing of any issuances to be made pursuant to the  
4 requested authorization would be dictated by then prevailing market conditions  
5 as would the terms and conditions of such issuances, including the type of  
6 security (mortgage, deed of trust, letter of credit, standby purchase  
7 agreement, etc.), if any, provided therefor.

8 8. The reasonableness of such timing as well as of terms and conditions  
9 of sale would be governed by the exercise in good faith of prudent business  
10 judgement.

11 9. APS does not anticipate that it will actually have to issue all of  
12 the debt for which authorization is being sought.

13 10. The financing flexibility sought herein and as previously granted by  
14 Decision No. 54230 has permitted APS to take advantage of rapid and sometimes  
15 unanticipated changes in the capital markets.

16 11. Upon the issuance of all the debt for which authorization is sought  
17 herein, APS would have adequate operating income to service such debt under  
18 existing rates for electric service.

19 12. After issuance of all the debt for which authorization is sought  
20 herein, APS's financial ratios as to interest coverage, long-term debt, cash  
21 flow, and common equity would be below those of comparable investment grade  
22 investor-owned utilities, thus creating some risk of down-rating to  
23 sub-investment grade.

24 13. Although such a down-rating would be significantly harmful to both  
25 APS and its ratepayers, the risk of its occurrence is small and can be further  
26 reduced by either APS receiving rate relief in its pending rate application or  
27 by a reduction in discretionary expenditures or by a combination of both.

28 14. There is no reason to believe that any other form of long-term

1 financing would on a risk adjusted basis prove to be less expensive to APS and  
2 its ratepayers.

3 15. With the possible exception of the Nuclear Fuel Debt and the payment  
4 of certain of APS's working capital and other cash requirements, none of the  
5 purposes for which debt is to be issued pursuant to the authorization sought  
6 herein is reasonably chargeable to operating expense or income.

7 16. The proposed financing and the authorizations in connection  
8 therewith are reasonably necessary for the purposes set forth herein and in the  
9 Application.

10 17. The proposed financing program is compatible with sound financial  
11 practices and with APS's obligations as a public service corporation and will  
12 not impair its ability to provide service to the public.

13 18. The proposed financing program has been approved by APS's board of  
14 directors.

#### 15 CONCLUSIONS OF LAW

16 1. APS is a public service corporation within the meaning of Article XV  
17 of the Arizona Constitution and A.R.S. §§40-301, et seq.

18 2. The Commission has jurisdiction over APS and of the subject matter  
19 of the Application.

20 3. The proposed financing plan, as described herein and in APS's  
21 Application, is for lawful purposes within the corporate powers of APS and is  
22 compatible with the public interest.

#### 23 ORDER

24 IT IS THEREFORE ORDERED that Arizona Public Service Company be, and the  
25 same is hereby authorized:"

26 (a) to issue, sell, and incur up to \$275,000,000 in aggregate  
27 principal amount of New Debt, to issue, sell, and incur the  
28 Continuing Debt, and to amend the terms and provisions of

1                   outstanding long-term indebtedness:

2                   (b) to execute and deliver one or more supplemental indentures to  
3                   the Arizona Public Service Company's Mortgage and Deed of Trust  
4                   as may be deemed appropriate by Arizona Public Service Company  
5                   in connection with the New Debt and Continuing Debt:

6                   (c) to issue, sell, and incur up to \$200,000,000 in aggregate  
7                   principal amount of Nuclear Fuel Debt: and,

8                   (d) to pay related expenses, all as contemplated in the Application  
9                   and by the exhibits and testimony filed in connection  
10                  therewith.

11               IT IS FURTHER ORDERED that Arizona Public Service Company is hereby  
12               authorized to sign and deliver such documents and to engage in such acts as are  
13               reasonably necessary to effectuate the authorization granted hereinabove.

14               IT IS FURTHER ORDERED that the purposes for which the proposed issuances  
15               of New Debt and Continuing Debt are herein authorized are to augment the funds  
16               available from all sources to finance Arizona Public Service Company's  
17               construction program, to redeem or retire outstanding securities, to repay or  
18               refund other outstanding long-term debt, to repay short-term debt which has  
19               previously financed construction projects, and, if necessary, to meet certain  
20               working capital and other cash requirements, regardless of the extent to which  
21               such purposes may be reasonably chargeable to operative expenses or to income.

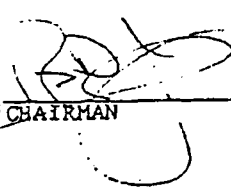
22               IT IS FURTHER ORDERED that the purposes for which the proposed issuances  
23               of Nuclear Fuel Debt are herein authorized are to finance the Arizona Public  
24               Service Company's nuclear fuel requirements in connection with the operation of  
25               the Palo Verde Nuclear Generating Station, and/or to refund or roll-over the  
26               Nuclear Fuel Debt, which purposes are hereby specifically authorized regardless  
27               of the extent to which they may be reasonably chargeable to operative expenses  
28               or to income.



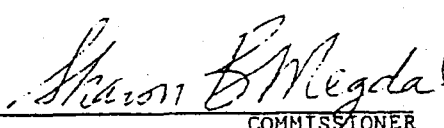
1 IT IS FURTHER ORDERED that the Commission's authorization of the above  
2 financing does not constitute approval of any particular expenditure of the  
3 proceeds derived thereby for the purposes of setting just and reasonable rates.

4 IT IS FURTHER ORDERED that this Decision shall become effective  
5 immediately.

6 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

7  
8   
9 CHAIRMAN

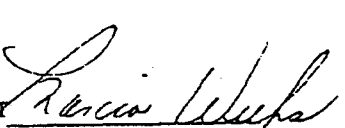
COMMISSIONER

10   
11 COMMISSIONER

12 IN WITNESS WHEREOF, I, JAMES MATTHEWS, Executive  
13 Secretary of the Arizona Corporation Commission, have  
14 hereunto set my hand and caused the official seal of  
15 this Commission to be affixed at the Capitol, in the  
16 City of Phoenix, this 6 day of May,  
17 1986.

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19 JAMES MATTHEWS  
20 Executive Secretary

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EXHIBIT C

Pinnacle West Capital Corporation  
and  
Arizona Public Service Company  
September 30, 2006 Form 10-Q

**FORM 10-Q**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

(Mark One)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended June 30, 2006**

**OR**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

<b>Commission File Number</b>	<b>Exact Name of Each Registrant as specified in its charter; State of Incorporation; Address; and Telephone Number</b>	<b>IRS Employer Identification No.</b>
1-8962	<b>PINNACLE WEST CAPITAL CORPORATION</b> (an Arizona corporation) 400 North Fifth Street, P.O. Box 53999 Phoenix, Arizona 85072-3999 (602) 250-1000	86-0512431
1-4473	<b>ARIZONA PUBLIC SERVICE COMPANY</b> (an Arizona corporation) 400 North Fifth Street, P.O. Box 53999 Phoenix, Arizona 85072-3999 (602) 250-1000	86-0011170

Indicate by check mark whether each registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

PINNACLE WEST CAPITAL CORPORATION	Yes <input checked="" type="checkbox"/>	No <input type="checkbox"/>
ARIZONA PUBLIC SERVICE COMPANY	Yes <input checked="" type="checkbox"/>	No <input type="checkbox"/>

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act.

PINNACLE WEST CAPITAL CORPORATION	Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/>
ARIZONA PUBLIC SERVICE COMPANY	Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input checked="" type="checkbox"/>

Indicate by check mark whether each registrant is a shell company (as defined in Exchange Act Rule 12b-2).

PINNACLE WEST CAPITAL CORPORATION	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>
ARIZONA PUBLIC SERVICE COMPANY	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

PINNACLE WEST CAPITAL CORPORATION	Number of shares of common stock, no par value, outstanding as of August 4, 2006: 99,477,663
-----------------------------------	---

ARIZONA PUBLIC SERVICE COMPANY	Number of shares of common stock, \$2.50 par value, outstanding as of August 4, 2006: 71,264,947
--------------------------------	---

**Arizona Public Service Company meets the conditions set forth in General Instruction H(1)(a) and (b) of Form 10-Q and is therefore filing this form with the reduced disclosure format allowed under that General Instruction.**

This combined Form 10-Q is separately filed by Pinnacle West Capital Corporation and Arizona Public Service Company. Each registrant is filing on its own behalf all of the information contained in this Form 10-Q that relates to such registrant and, where required, its subsidiaries. Except as stated in the preceding sentence, neither registrant is filing any information that does not relate to such registrant, and therefore makes no representation as to any such information.

## TABLE OF CONTENTS

	Page
Glossary .....	2
Part I .....	4
Item 1. Financial Statements .....	4
Pinnacle West Capital Corporation .....	4
Arizona Public Service Company .....	32
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations .....	42
Item 3. Quantitative and Qualitative Disclosures About Market Risk .....	68
Item 4. Controls and Procedures .....	68
Part II .....	69
Item 1. Legal Proceedings .....	69
Item 1A. Risk Factors .....	69
Item 4. Submission of Matters to a Vote of Security Holders .....	70
Item 5. Other Information .....	70
Item 6. Exhibits .....	72
Signatures .....	74

## GLOSSARY

ACC – Arizona Corporation Commission  
ADEQ – Arizona Department of Environmental Quality  
ALJ – Administrative Law Judge  
APB – Accounting Principles Board  
APS – Arizona Public Service Company, a subsidiary of the Company  
APS Energy Services – APS Energy Services Company, Inc., a subsidiary of the Company  
Clean Air Act – Clean Air Act, as amended  
Company – Pinnacle West Capital Corporation  
DOE – United States Department of Energy  
EITF – FASB's Emerging Issues Task Force  
El Dorado – El Dorado Investment Company, a subsidiary of the Company  
EPA – United States Environmental Protection Agency  
ERMC – Energy Risk Management Committee  
FASB – Financial Accounting Standards Board  
FERC – United States Federal Energy Regulatory Commission  
FIP – Federal Implementation Plan  
GAAP – accounting principles generally accepted in the United States of America  
IRS – United States Internal Revenue Service  
kWh – kilowatt-hour  
Moody's – Moody's Investors Service  
MWh – megawatt-hour, one million watts per hour  
Native Load – retail and wholesale sales supplied under traditional cost-based rate regulation  
NPC – Nevada Power Company  
NRC – United States Nuclear Regulatory Commission  
OCI – other comprehensive income  
Off-System Sales – sales of electricity from generation owned by the Company that is over and above the amount required to serve APS' retail customers and traditional wholesale contracts  
Palo Verde – Palo Verde Nuclear Generating Station  
Pinnacle West – Pinnacle West Capital Corporation, the Company  
Pinnacle West Energy – Pinnacle West Energy Corporation, a subsidiary of the Company  
PRP – potentially responsible party  
PSA – power supply adjustor

PWEC Dedicated Assets – the following power plants, each of which was transferred by Pinnacle West Energy to APS on July 29, 2005: Redhawk Units 1 and 2, West Phoenix Units 4 and 5 and Saguaro Unit 3

Salt River Project – Salt River Project Agricultural Improvement and Power District

SEC – United States Securities and Exchange Commission

SFAS – Statement of Financial Accounting Standards

Silverhawk – Silverhawk Power Station, a 570-megawatt, natural gas-fueled, combined-cycle electric generating facility located 20 miles north of Las Vegas, Nevada

Standard & Poor's – Standard & Poor's Corporation

SunCor – SunCor Development Company, a subsidiary of the Company

Sundance Plant – 450-megawatt generating facility located approximately 55 miles southeast of Phoenix, Arizona

Superfund – Comprehensive Environmental Response, Compensation and Liability Act

Trading – energy-related activities entered into with the objective of generating profits on changes in market prices

2005 Form 10-K – Pinnacle West/APS Annual Report on Form 10-K for the fiscal year ended December 31, 2005

VIE – variable interest entity

# **PART I – FINANCIAL INFORMATION**

## **ITEM 1. FINANCIAL STATEMENTS**

### **PINNACLE WEST CAPITAL CORPORATION** **CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)

(dollars and shares in thousands, except per share amounts)

	Three Months Ended June 30,	
	2006	2005
<b>OPERATING REVENUES</b>		
Regulated electricity segment	\$ 712,718	\$ 579,652
Marketing and trading segment	89,925	71,172
Real estate segment	112,603	84,259
Other revenues	9,782	20,259
Total	<u>925,028</u>	<u>755,342</u>
<b>OPERATING EXPENSES</b>		
Regulated electricity segment fuel and purchased power	263,944	160,590
Marketing and trading segment fuel and purchased power	72,716	57,593
Operations and maintenance	168,332	153,097
Real estate segment operations	98,412	67,713
Depreciation and amortization	89,297	85,323
Taxes other than income taxes	32,700	34,638
Other expenses	8,430	17,556
Total	<u>733,831</u>	<u>576,510</u>
<b>OPERATING INCOME</b>	<u>191,197</u>	<u>178,832</u>
<b>OTHER</b>		
Allowance for equity funds used during construction	3,633	2,952
Other income (Note 14)	12,022	8,684
Other expense (Note 14)	(5,815)	(3,846)
Total	<u>9,840</u>	<u>7,790</u>
<b>INTEREST EXPENSE</b>		
Interest charges	45,882	50,077
Capitalized interest	(4,959)	(3,544)
Total	<u>40,923</u>	<u>46,533</u>
<b>INCOME FROM CONTINUING OPERATIONS</b>		
BEFORE INCOME TAXES	160,114	140,089
<b>INCOME TAXES</b>	49,271	54,988
<b>INCOME FROM CONTINUING OPERATIONS</b>	<u>110,843</u>	<u>85,101</u>
<b>INCOME (LOSS) FROM DISCONTINUED OPERATIONS</b>		
Net of income tax expense (benefit) of \$855 and \$(37,673) (Note 17)	1,311	(58,366)
<b>NET INCOME</b>	<u>\$ 112,154</u>	<u>\$ 26,735</u>
<b>WEIGHTED-AVERAGE COMMON SHARES</b>		
OUTSTANDING – BASIC	99,221	96,192
<b>WEIGHTED-AVERAGE COMMON SHARES</b>		
OUTSTANDING – DILUTED	99,640	96,299
<b>EARNINGS PER WEIGHTED – AVERAGE</b>		
<b>COMMON SHARE OUTSTANDING</b>		
Income from continuing operations – basic	\$ 1.12	\$ 0.88
Net income – basic	1.13	0.28
Income from continuing operations – diluted	1.11	0.88
Net income – diluted	1.13	0.28
<b>DIVIDENDS DECLARED PER SHARE</b>	\$ -	\$ -

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

**PINNACLE WEST CAPITAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(unaudited)

(dollars and shares in thousands, except per share amounts)

	Six Months Ended June 30,	
	2006	2005
<b>OPERATING REVENUES</b>		
Regulated electricity segment	\$ 1,178,844	\$ 995,682
Marketing and trading segment	174,927	160,429
Real estate segment	220,457	154,195
Other revenues	21,006	30,394
Total	<u>1,595,234</u>	<u>1,340,700</u>
<b>OPERATING EXPENSES</b>		
Regulated electricity segment fuel and purchased power	421,339	239,013
Marketing and trading segment fuel and purchased power	146,891	128,402
Operations and maintenance	346,759	308,181
Real estate segment operations	169,742	123,047
Depreciation and amortization	176,918	176,267
Taxes other than income taxes	68,273	69,203
Other expenses	16,952	25,930
Total	<u>1,346,874</u>	<u>1,070,043</u>
<b>OPERATING INCOME</b>	<u>248,360</u>	<u>270,657</u>
<b>OTHER</b>		
Allowance for equity funds used during construction	7,434	5,555
Other income (Note 14)	17,489	9,487
Other expense (Note 14)	(10,356)	(8,232)
Total	<u>14,567</u>	<u>6,810</u>
<b>INTEREST EXPENSE</b>		
Interest charges	93,408	96,042
Capitalized interest	(8,983)	(6,833)
Total	<u>84,425</u>	<u>89,209</u>
<b>INCOME FROM CONTINUING OPERATIONS</b>		
BEFORE INCOME TAXES	178,502	188,258
<b>INCOME TAXES</b>	<u>56,064</u>	<u>73,558</u>
<b>INCOME FROM CONTINUING OPERATIONS</b>	<u>122,438</u>	<u>114,700</u>
<b>INCOME (LOSS) FROM DISCONTINUED OPERATIONS</b>		
Net of income tax expense (benefit) of \$1,412 and \$(40,992) (Note 17)	2,171	(63,517)
<b>NET INCOME</b>	<u>\$ 124,609</u>	<u>\$ 51,183</u>
<b>WEIGHTED-AVERAGE COMMON SHARES</b>		
OUTSTANDING - BASIC	99,168	94,089
<b>WEIGHTED-AVERAGE COMMON SHARES</b>		
OUTSTANDING - DILUTED	99,562	94,189
<b>EARNINGS PER WEIGHTED - AVERAGE</b>		
<b>COMMON SHARE OUTSTANDING</b>		
Income from continuing operations - basic	\$ 1.23	\$ 1.22
Net income - basic	1.26	0.54
Income from continuing operations - diluted	1.23	1.22
Net income - diluted	1.25	0.54
<b>DIVIDENDS DECLARED PER SHARE</b>	\$ 1.00	\$ 0.95

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.



**PINNACLE WEST CAPITAL CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(unaudited)  
(dollars in thousands)

	June 30, 2006	December 31, 2005
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 15,608	\$ 154,003
Customer and other receivables	510,086	502,681
Allowance for doubtful accounts	(4,868)	(4,979)
Materials and supplies (at average cost)	112,891	109,736
Fossil fuel (at average cost)	25,210	23,658
Assets from risk management and trading activities (Note 10)	473,551	827,779
Assets held for sale (Note 17)	22,568	202,645
Other current assets	78,607	75,869
Total current assets	<u>1,233,653</u>	<u>1,891,392</u>
<b>INVESTMENTS AND OTHER ASSETS</b>		
Real estate investments – net	453,947	390,702
Assets from long-term risk management and trading activities (Note 10)	321,131	597,831
Decommissioning trust accounts (Note 18)	306,981	293,943
Other assets	118,034	111,931
Total investments and other assets	<u>1,200,093</u>	<u>1,394,407</u>
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Plant in service and held for future use	10,974,195	10,727,695
Less accumulated depreciation and amortization	3,725,592	3,622,884
Total	7,248,603	7,104,811
Construction work in progress	337,949	327,172
Intangible assets, net of accumulated amortization	101,293	90,916
Nuclear fuel, net of accumulated amortization	57,394	54,184
Net property, plant and equipment	<u>7,745,239</u>	<u>7,577,083</u>
<b>DEFERRED DEBITS</b>		
Deferred fuel and purchased power regulatory asset (Note 5)	174,666	172,756
Other regulatory assets	176,018	151,123
Other deferred debits	120,030	135,884
Total deferred debits	<u>470,714</u>	<u>459,763</u>
<b>TOTAL ASSETS</b>	<u><u>\$ 10,649,699</u></u>	<u><u>\$ 11,322,645</u></u>

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

**PINNACLE WEST CAPITAL CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(unaudited)  
(dollars in thousands)

	June 30, 2006	December 31, 2005
<b>LIABILITIES AND COMMON STOCK EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 293,386	\$ 377,107
Accrued taxes	336,338	289,235
Accrued interest	26,455	31,774
Short-term borrowings	174,019	15,673
Current maturities of long-term debt	85,601	384,947
Customer deposits	66,952	60,509
Deferred income taxes	24,845	94,710
Liabilities from risk management and trading activities (Note 10)	399,368	720,693
Other current liabilities (Note 10)	153,245	297,425
Total current liabilities	<u>1,560,209</u>	<u>2,272,073</u>
<b>LONG-TERM DEBT LESS CURRENT MATURITIES</b>	<u>2,815,665</u>	<u>2,608,455</u>
<b>DEFERRED CREDITS AND OTHER</b>		
Deferred income taxes	1,200,030	1,225,253
Regulatory liabilities	570,697	592,494
Liability for asset retirements	277,592	269,011
Pension liability	284,060	264,476
Liabilities from long-term risk management and trading activities (Note 10)	243,886	256,413
Unamortized gain – sale of utility plant	43,469	45,757
Other	369,162	363,749
Total deferred credits and other	<u>2,988,896</u>	<u>3,017,153</u>
<b>COMMITMENTS AND CONTINGENCIES (Notes 5, 12, 13 and 15)</b>		
<b>COMMON STOCK EQUITY</b>		
Common stock, no par value	2,079,774	2,067,377
Treasury stock	(895)	(1,245)
Total common stock	<u>2,078,879</u>	<u>2,066,132</u>
Accumulated other comprehensive income (loss) (Note 11):		
Minimum pension liability adjustment	(97,277)	(97,277)
Derivative instruments	84,233	262,397
Total accumulated other comprehensive income	<u>(13,044)</u>	<u>165,120</u>
Retained earnings	<u>1,219,094</u>	<u>1,193,712</u>
Total common stock equity	<u>3,284,929</u>	<u>3,424,964</u>
<b>TOTAL LIABILITIES AND COMMON STOCK EQUITY</b>	<u>\$ 10,649,699</u>	<u>\$ 11,322,645</u>

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

**PINNACLE WEST CAPITAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(unaudited)  
(dollars in thousands)

	Six Months Ended June 30,	
	2006	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Income	\$ 124,609	\$ 51,183
Adjustments to reconcile net income to net cash provided by operating activities:		
Silverhawk impairment loss	—	91,057
Depreciation and amortization including nuclear fuel	188,863	185,613
Deferred fuel and purchased power	(94,565)	(33,785)
Deferred fuel and purchased power amortization	92,656	—
Allowance for equity funds used during construction	(7,434)	(5,555)
Deferred income taxes	16,481	(36,209)
Change in mark-to-market valuations	11,730	(17,436)
Changes in current assets and liabilities:		
Customer and other receivables	(764)	344
Materials, supplies and fossil fuel	580	(15,773)
Other current assets	3,806	(27,571)
Accounts payable	(91,543)	(107,299)
Accrued taxes	50,074	70,268
Other current liabilities	5,754	16,726
Proceeds from the sale of real estate assets	15,482	41,259
Real estate investments	(61,758)	(39,968)
Change in risk management and trading – assets	64,893	16,360
Change in risk management and trading – liabilities	(132,448)	5,603
Change in collateral	(155,354)	91,969
Change in other long-term assets	4,532	6,016
Change in other long-term liabilities	20,631	41,344
Net cash flow provided by operating activities	<u>56,225</u>	<u>334,146</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures	(363,795)	(302,880)
Capitalized interest	(8,983)	(6,833)
Purchase of Sundance	—	(185,046)
Proceeds from the sale of Silverhawk	207,620	—
Purchases of investment securities	(280,527)	(1,579,906)
Proceeds from sale of investment securities	280,527	1,431,348
Proceeds from nuclear decommissioning trust sales	114,875	82,764
Investment in nuclear decommissioning trust	(125,246)	(90,814)
Other	1,618	2,724
Net cash flow used for investing activities	<u>(173,911)</u>	<u>(648,643)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Issuance of long-term debt	255,984	664,003
Repayment of long-term debt	(353,549)	(430,673)
Short-term borrowings and payments – net	158,336	16,253
Dividends paid on common stock	(99,227)	(90,364)
Common stock equity issuance	8,910	271,069
Other	8,837	21,246
Net cash flow provided by (used for) financing activities	<u>(20,709)</u>	<u>451,534</u>
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<u>(138,395)</u>	<u>137,037</u>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<u>154,003</u>	<u>163,366</u>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<u><u>\$ 15,608</u></u>	<u><u>\$ 300,403</u></u>
<b>Supplemental disclosure of cash flow information</b>		
Cash paid during the period for:		
Income taxes, net of refunds	\$ 251	\$ 7,733
Interest, net of amounts capitalized	\$ 87,290	\$ 87,617

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Consolidation and Nature of Operations**

The unaudited condensed consolidated financial statements include the accounts of Pinnacle West and our wholly-owned subsidiaries: APS, Pinnacle West Energy, APS Energy Services, SunCor and El Dorado. All significant intercompany accounts and transactions between the consolidated companies have been eliminated. Our accounting records are maintained in accordance with GAAP. The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. We have reclassified certain prior year amounts to conform to the current year presentation.

**2. Condensed Consolidated Financial Statements**

Our unaudited condensed consolidated financial statements reflect all adjustments which we believe are necessary for the fair presentation of our financial position, results of operations and cash flows for the periods presented. We suggest that these condensed consolidated financial statements and notes to condensed consolidated financial statements be read along with the consolidated financial statements and notes to consolidated financial statements included in our 2005 Form 10-K.

**3. Quarterly Fluctuations**

Weather conditions cause significant seasonal fluctuations in our revenues. In addition, real estate and trading and wholesale marketing activities can have significant impacts on our results for interim periods. For these reasons, results for interim periods do not necessarily represent results to be expected for the year.

**4. Changes in Liquidity**

In January 2006, Pinnacle West infused into APS \$210 million of the proceeds from the sale of Silverhawk. See "Equity Infusions" in Note 5 for more information.

On February 28, 2006, Pinnacle West entered into an Uncommitted Master Shelf Agreement with Prudential Investment Management, Inc. ("Prudential") and certain of its affiliates. The agreement provides the terms under which Pinnacle West may offer up to \$200 million of its senior notes for purchase by Prudential affiliates at any time prior to December 31, 2007. The maturity of notes issued under the agreement cannot exceed five years. Pursuant to the agreement, on February 28, 2006, Pinnacle West issued and sold to Prudential affiliates \$175 million of its 5.91% Senior Notes, Series A, due February 28, 2011 (the "Series A Notes").

On April 3, 2006, Pinnacle West repaid \$300 million of its 6.40% Senior Notes due April 2006. Pinnacle West used the proceeds of the Series A Notes, cash on hand and commercial paper proceeds to repay these notes.

On August 3, 2006, APS issued \$400 million of debt as follows: \$250 million of its 6.25% Notes due 2016 and \$150 million of its 6.875% Notes due 2036. A portion of the proceeds will be used to pay at maturity approximately \$84 million of APS' 6.75% Senior Notes due November 15,

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

2006, to fund its construction program and for other general corporate purposes. A portion of the proceeds may also be used to pay any liability determined to be payable as a result of the review by the Internal Revenue Service of a tax refund the Company received in 2002.

The following table shows principal payments due on Pinnacle West's and APS' total long-term debt and capitalized lease requirements (dollars in millions) as of June 30, 2006:

Year	Pinnacle West	APS
2006	\$ 86	\$ 85
2007	2	1
2008	130	1
2009	27	1
2010	227	224
Thereafter	2,438	2,261
Total	\$ 2,910	\$ 2,573

**5. Regulatory Matters**

**APS General Rate Case**

On January 31, 2006, APS filed with the ACC updated financial schedules, testimony and other data in the general rate case that APS originally filed on November 4, 2005. As requested by the ACC staff, the updated information uses the twelve months ended September 30, 2005 as the test period instead of the test year ended December 31, 2004 used in APS' original filing. As a result of the updated filing, APS is requesting a 21.3%, or \$453.9 million, increase in its annual retail electricity revenues effective no later than December 31, 2006. The original filing requested a 19.9%, or \$409.1 million, retail rate increase.

The updated requested rate increase is designed to recover the following (dollars in millions):

	Updated Filing (January 31, 2006)		Original Filing (November 4, 2005)	
	Annual Revenue Increase	Percentage Increase	Annual Revenue Increase	Percentage Increase
Increased fuel and purchased power	\$ 299.0	14.0%	\$ 246.8	12.0%
Capital structure update	98.3	4.6%	96.8	4.7%
Rate base update, including acquisition of Sundance Plant	46.2	2.2%	42.5	2.1%
Pension funding	41.3	1.9%	41.2	2.0%
Other items	(30.9)	(1.4)%	(18.2)	(0.9)%
Total increase	\$ 453.9	21.3%	\$ 409.1	19.9%

The request is based on (a) a rate base of \$4.4 billion as of September 30, 2005; (b) a base rate for fuel and purchased power costs of \$0.031904 per kilowatt-hour based on estimated 2006

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

prices; and (c) a proposed capital structure of 45% long-term debt and 55% common stock equity, with a weighted-average cost of capital of 8.73% (5.41% for long-term debt and 11.50% for common stock equity). The requested increase in annual retail electricity revenues from the original filing is based solely on increased fuel and purchased power costs, slightly offset by other items (see the above chart). If the ACC approves the requested base rate increase for fuel and purchased power costs (see clause (b) of this paragraph), subsequent PSA rate adjustments and/or PSA surcharges would be reduced because more of such costs would be recovered in base rates.

The updated request does not include the PSA annual adjustor rate increase of approximately 5% that took effect February 1, 2006, the PSA surcharge increase of approximately 0.7% that took effect May 1, 2006, or APS' pending application for a 1.9% PSA surcharge rate increase. See "Power Supply Adjustor" below. The interim rate increase described immediately below would, if it becomes permanent, accelerate the recovery of a portion of the fuel and purchased power component of the general rate case request.

**Interim Rate Increase**

On January 6, 2006, APS filed with the ACC an application requesting an emergency interim rate increase of \$299 million, or approximately 14%, to be effective April 1, 2006. APS later reduced this request to \$232 million, or approximately 11%, due to a decline in expected 2006 natural gas and wholesale power prices. The purpose of the emergency interim rate increase was solely to address APS' under-collection of higher annual fuel and purchased power costs. On May 2, 2006, the ACC approved an order in this matter that, among other things:

- authorized an interim PSA adjustor, effective May 1, 2006, that resulted in an interim retail rate increase of approximately 8.3% designed to recover approximately \$138 million of fuel and purchased power costs incurred in 2006 (this interim adjustor, combined with the \$15 million PSA surcharge approved by the ACC (see "Surcharge for Certain 2005 PSA Deferrals" below), resulted in a rate increase of approximately 9.0% designed to recover approximately \$149 million of fuel and purchased power costs during 2006);
- provides that amounts collected through the interim PSA adjustor "remain subject to a prudence review at the appropriate time" and that "all unplanned Palo Verde outage costs for 2006 should undergo a prudence audit by [the ACC] Staff" (see "PSA Deferrals Related to Unplanned Palo Verde Outages" below);
- encourages parties to APS' general rate case to "propose modifications to the PSA that will address on a permanent basis, the issues with timing of recovery when deferrals are large and growing";
- affirmed APS' ability to defer fuel and purchased power costs above the prior annual cap of \$776.2 million until the ACC decides the general rate case; and
- encourages APS to diversify its resources "through large scale, sustained energy efficiency programs, [using] low cost renewable energy resources as a hedge against high fossil fuel costs."

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

As noted above, the interim PSA adjustor would, if it becomes permanent, accelerate the recovery of a portion of the fuel and purchased power component of APS' general rate case and is not an additional increase.

**Power Supply Adjustor**

**PSA Provisions**

The PSA approved by the ACC in April 2005 as part of APS' 2003 rate case provides for adjustment of retail rates to reflect variations in retail fuel and purchased power costs. On January 25, 2006, the ACC modified the PSA in certain respects. The PSA, as modified, is subject to specified parameters and procedures, including the following:

- APS will record deferrals for recovery or refund to the extent actual retail fuel and purchased power costs vary from the base fuel amount (currently \$0.020743 per kWh);
- the deferrals are subject to a 90/10 sharing arrangement in which APS must absorb 10% of the retail fuel and purchased power costs above the base fuel amount and may retain 10% of the benefit from the retail fuel and purchased power costs that are below the base fuel amount;
- amounts to be recovered or refunded through the PSA adjustor are limited to a) a cumulative plus or minus \$0.004 per kWh from the base fuel amount over the life of the PSA and b) a maximum plus or minus \$0.004 change in the adjustor rate in any one year;
- the recoverable amount of annual retail fuel and purchased power costs through current base rates and the PSA was originally capped at \$776.2 million; however, the ACC has removed the cap pending the ACC's final ruling on APS' pending request in the general rate case to have the cap eliminated or substantially raised;
- the PSA will remain in effect for a minimum five-year period, but the ACC may eliminate the PSA at any time, if appropriate, in the event APS files a rate case before the expiration of the five-year period (which APS did by filing the general rate case noted above) or if APS does not comply with the terms of the PSA; and
- APS is prohibited from requesting PSA surcharges until after the PSA annual adjustor rate has been set each year. The amount available for potential PSA surcharges will be limited to the amount of accumulated deferrals through the prior year-end, which are not expected to be recovered through the annual adjustor or any PSA surcharges previously approved by the ACC.

**2006 PSA Annual Adjustor** The effective date of the PSA's annual adjustor is February 1, 2006 and the adjustor rate was set at the maximum \$0.004 per kilowatt-hour effective February 1, 2006. The change in the adjustor rate represents a retail rate increase of approximately 5% designed to recover \$110 million of deferred fuel and purchased power costs over the twelve-month period beginning February 1, 2006.

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Surcharge for Certain 2005 PSA Deferrals** On April 12, 2006, the ACC approved APS' request to recover \$15 million of 2005 PSA deferrals over a twelve-month period beginning May 2, 2006, representing a temporary rate increase of approximately 0.7%. Approximately \$45 million of 2005 PSA deferrals remain subject to a pending application (see "PSA Deferrals Related to Unplanned Palo Verde Outages" below); the balance of the 2005 PSA deferrals is being recovered under the 2006 PSA annual adjustor described in the preceding paragraph.

**PSA Deferrals Related to Unplanned Palo Verde Outages** On February 2, 2006, APS filed with the ACC an application to recover approximately \$45 million over a twelve-month period, representing a temporary rate increase of approximately 1.9%, proposed to begin no later than the ACC's completion of its inquiry regarding the unplanned 2005 Palo Verde outages.

As noted under "Interim Rate Increase" above, the ACC has directed the ACC staff to conduct a "prudence audit" on unplanned 2006 Palo Verde outage costs. PSA deferrals related to these 2006 outages are estimated to be about \$70 million.

**Proposed Modifications to PSA (Requested In General Rate Case)**

In its pending general rate case, APS has requested the following modifications to the PSA:

- The cumulative plus or minus \$0.004 per kWh limit from the base fuel amount over the life of the PSA would be eliminated, while the maximum plus or minus \$0.004 limit to changes in the adjustor rate in any one year would remain in effect;
- The \$776.2 million annual limit on the retail fuel and purchased power costs under APS' current base rates and the PSA would be removed or increased (although APS may defer fuel and purchased power costs above \$776.2 million per year pending the ACC's final ruling on APS' pending request to have the cap eliminated or substantially raised);
- The current provision that APS is required to file a surcharge application with the ACC after accumulated pretax PSA deferrals equal \$50 million and before they equal \$100 million would be eliminated, thereby giving APS flexibility in determining when a surcharge filing should be made;
- The costs of renewable energy and capacity costs attributable to purchased power obtained through competitive procurement would be excluded from the existing 90/10 sharing arrangement under which APS absorbs 10% of the retail fuel and purchased power costs above the base fuel amount and retains 10% of the benefit from retail fuel and purchased power costs that are below the base fuel amount; and
- 10% of any realized gains or losses resulting from APS' hedges of retail fuel and purchased power costs would be retained or absorbed by APS before being subject to the 90/10 sharing provision under the PSA.



**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Equity Infusions**

On November 8, 2005, the ACC approved Pinnacle West's request to infuse more than \$450 million of equity into APS during 2005 or 2006. These infusions consist of about \$250 million of the proceeds of Pinnacle West's common equity issuance on May 2, 2005 and about \$210 million of the proceeds from the sale of Silverhawk in January 2006 (see Note 17). Pinnacle West has made these equity infusions into APS.

**Federal**

**Price Mitigation Plan**

In July 2002, the FERC adopted a price mitigation plan that constrains the price of electricity in the wholesale spot electricity market in the western United States. The FERC adopted a price cap of \$250 per MWh for the period subsequent to October 31, 2002. On February 13, 2006, the FERC increased this price cap to \$400 per MWh for prospective sales. Sales at prices above the cap must be justified and are subject to potential refund.

**FERC Order**

On August 11, 2004, Pinnacle West, APS, Pinnacle West Energy, and APS Energy Services (collectively, the "Pinnacle West Companies") submitted to the FERC an update to its three-year market-based rate review pursuant to the FERC's order implementing a new generation market power analysis. On December 20, 2004, the FERC issued an order approving the Pinnacle West Companies' market-based rates for control areas other than those of APS, Public Service Company of New Mexico ("PNM") and Tucson Electric Power Company ("TEP"). The FERC staff required the Pinnacle West Companies to submit additional data with respect to these control areas, and the Pinnacle West Companies did so.

On April 17, 2006, the FERC issued an order revoking the Pinnacle West Companies' market-based rate authority in the APS control area (the "FERC Order"). The FERC found that the Pinnacle West Companies failed to provide the necessary information about the APS control area to allow the FERC to make a determination about the FERC's generation market power "screens" in the APS control area. The FERC found that the Pinnacle West Companies may charge market-based rates in the PNM and TEP control areas.

As a result of the FERC Order, the Pinnacle West Companies must charge cost-based rates, rather than market-based rates, in the APS control area for sales occurring after the date of the order, April 17, 2006. The Pinnacle West Companies are required to refund any amounts collected that exceed the default cost-based rates for all market rate sales within the APS control area from February 27, 2005 to April 17, 2006.

The Pinnacle West Companies filed a rehearing request of the FERC Order on May 17, 2006 and requested a technical conference with the FERC staff to discuss the order. The rehearing request is still pending. The FERC granted the request to hold a technical conference so that FERC staff and the Pinnacle West Companies may discuss how to implement the cost-based mitigation requirements of the FERC Order. The technical conference was held on July 10, 2006, and the Pinnacle West Companies submitted a supplemental compliance filing on July 31, 2006. Based upon an analysis of

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

the FERC Order and preliminary calculations of the refund obligations, at this time, neither Pinnacle West nor APS believes that the FERC Order will have a material adverse effect on its financial position, results of operations or cash flows.

**6. Retirement Plans and Other Benefits**

Pinnacle West sponsors a qualified defined benefit and account balance pension plan, a nonqualified supplemental excess benefit retirement plan, and other postretirement benefit plans for the employees of Pinnacle West and our subsidiaries. Pinnacle West uses a December 31 measurement date for its pension and other postretirement benefit plans. The market-related value of our plan assets is their fair value at the measurement date.

The following table provides details of the plans' benefit costs for the three and six months ended June 30, 2006 and 2005. Also included is the portion of these costs charged to expense, including administrative costs and excluding amounts billed to electric plant participants or capitalized as overhead construction (dollars in millions):

	Pension Benefits				Other Benefits			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005	2006	2005	2006	2005
Service cost-benefits earned during the period	\$ 9	\$ 11	\$ 24	\$ 23	\$ 2	\$ 5	\$ 10	\$ 11
Interest cost on benefit obligation	17	21	46	44	4	9	17	17
Expected return on plan assets	(18)	(21)	(48)	(44)	(4)	(8)	(18)	(16)
Amortization of:								
Transition (asset) obligation	--	(1)	(1)	(2)	--	1	2	2
Prior service cost	1	1	1	1	--	--	--	--
Net actuarial loss	4	4	12	10	1	2	4	5
Net periodic benefit cost	<u>\$ 13</u>	<u>\$ 15</u>	<u>\$ 34</u>	<u>\$ 32</u>	<u>\$ 3</u>	<u>\$ 9</u>	<u>\$ 15</u>	<u>\$ 19</u>
Portion of cost charged to expense	<u>\$ 5</u>	<u>\$ 6</u>	<u>\$ 14</u>	<u>\$ 13</u>	<u>\$ 1</u>	<u>\$ 4</u>	<u>\$ 6</u>	<u>\$ 8</u>
APS' share of costs charged to expense	<u>\$ 5</u>	<u>\$ 6</u>	<u>\$ 13</u>	<u>\$ 12</u>	<u>\$ 1</u>	<u>\$ 3</u>	<u>\$ 6</u>	<u>\$ 7</u>

**Contributions**

The contribution to our pension plan in 2006 is estimated to be approximately \$50 million, \$29 million of which has been contributed through June 30, 2006. The contribution to our other postretirement benefit plan in 2006 is estimated to be approximately \$29 million. APS' share is approximately 97% of both plans.

**7. Business Segments**

We have three principal business segments (determined by products, services and the regulatory environment):

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

- our regulated electricity segment, which consists of traditional regulated retail and wholesale electricity businesses (primarily electricity service to Native Load customers) and related activities and includes electricity generation, transmission and distribution;
- our real estate segment, which consists of SunCor's real estate development and investment activities; and
- our marketing and trading segment, which consists of our competitive energy business activities, including wholesale marketing and trading and APS Energy Services' commodity-related energy services.

Financial data for the three and six months ended June 30, 2006 and 2005 and at June 30, 2006 and December 31, 2005 by business segment is provided as follows (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Operating Revenues:				
Regulated electricity	\$ 713	\$ 580	\$ 1,179	\$ 996
Real estate	113	84	220	154
Marketing and trading	90	71	175	161
Other	9	20	21	30
Total	<u>\$ 925</u>	<u>\$ 755</u>	<u>\$ 1,595</u>	<u>\$ 1,341</u>
Net Income (Loss):				
Regulated electricity	\$ 95	\$ 69	\$ 82	\$ 83
Real estate	9	12	32	20
Marketing and trading(a)	7	(55)	10	(54)
Other	1	1	1	2
Total	<u>\$ 112</u>	<u>\$ 27</u>	<u>\$ 125</u>	<u>\$ 51</u>

- (a) The three and six months ended June 30, 2005 include a loss in discontinued operations related to the sale of Silverhawk of \$59 million and \$65 million, respectively.

	As of June 30, 2006	As of December 31, 2005
Assets:		
Regulated electricity	\$ 9,663	\$ 9,732
Real estate	564	483
Marketing and trading	391	1,070
Other	32	38
Total	<u>\$ 10,650</u>	<u>\$ 11,323</u>

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**8. Stock-Based Compensation**

Pinnacle West offers stock-based compensation plans for officers and key employees of Pinnacle West and our subsidiaries.

The 2002 Long-Term Incentive Plan ("2002 Plan") allows Pinnacle West to grant performance shares, stock ownership incentive awards and non-qualified and performance-accelerated stock options to key employees. We have reserved 6 million shares of common stock for issuance under the 2002 plan. No more than 1.8 million shares may be issued in relation to performance share awards and stock ownership incentive awards. The plan also provides for the granting of new non-qualified stock options at a price per share not less than the fair market value of the common stock at the time of grant. The stock options vest over three years, unless certain performance criteria are met, which can accelerate the vesting period. The terms of the options cannot be longer than 10 years and the options cannot be repriced.

Generally, each recipient of performance shares is entitled to receive shares of common stock at the end of a three-year period based upon Pinnacle West's earnings per share growth rate during that three-year period compared to the earnings per share growth rate of all relevant companies in a specified utilities index. The number of shares of common stock a recipient is entitled to receive is determined by Pinnacle West's relative percentile ranking during the three-year period.

The 1994 Long-Term Incentive Plan ("1994 Plan") includes outstanding options but no new options may be granted under the plan. Options vest one-third of the grant per year beginning one year after the date the option is granted and expire ten years from the date of the grant. The 1994 Plan also provided for the granting of any combination of shares of restricted stock, stock appreciation rights or dividend equivalents.

In the third quarter of 2002, we began applying the fair value method of accounting for stock-based compensation, as provided for in SFAS No. 123, "Accounting for Stock-Based Compensation." In accordance with the transition requirements of SFAS No. 123, we applied the fair value method prospectively, beginning with 2002 stock grants. In prior years, we recognized stock compensation expense based on the intrinsic value method allowed in APB No. 25, "Accounting for Stock Issued to Employees."

Effective January 1, 2006, we prospectively adopted SFAS No. 123(R), "Share-Based Payment." Because the fair value recognition provisions of both SFAS No. 123 and SFAS No. 123(R) are materially consistent with respect to our stock-based compensation plans, the adoption of SFAS No. 123(R) did not have a material impact on our financial statements.

The compensation cost that has been charged against income for share-based compensation plans was \$1.3 million and \$4.1 million for the three and six months ended June 30, 2006, respectively compared to \$1.6 million and \$2.2 million for the three and six months ended June 30, 2005, respectively. The total income tax benefit recognized in the condensed consolidated income statement for share-based compensation arrangements was \$0.5 million and \$1.5 million for the three and six months ended June 30, 2006, respectively, compared to \$0.6 million and \$0.9 million for the three and six months ended June 30, 2005, respectively.

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

The following table is a summary of option activity under our equity incentive plans as of June 30, 2006 and changes during the six months ending on that date:

Options	Shares (in thousands)	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (dollars in thousands)
Outstanding at				
January 1, 2006	1,696	\$ 39.65		
Exercised	(28)	33.00		
Forfeited or expired	(21)	43.92		
Outstanding at				
June 30, 2006	1,647	39.70	4.6	\$ 3,411
Exercisable at				
June 30, 2006	1,641	39.71	4.6	3,400

There were no options granted during the six months ended June 30, 2006 and 2005. The intrinsic value of options exercised during the three months ended June 30, 2006 and 2005 was \$0.2 million and \$0.6 million, respectively. The intrinsic value of options exercised during the six months ended June 30, 2006 and 2005 was \$0.2 million and \$1.1 million, respectively.

The following table is a summary of the status of stock compensation awards, other than options, as of June 30, 2006 and changes during the six months ending on that date:

Nonvested shares	Shares (in thousands)	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2006	528	\$ 38.23
Granted	274	41.50
Vested	(13)	44.13
Forfeited	(224)	36.10
Nonvested at June 30, 2006	565	40.52

As of June 30, 2006, there was \$8.6 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plan. That cost is expected to be recognized over a weighted-average period of 1.8 years. No shares vested during the three months ended June 30, 2006 and 2005. The total fair value of shares vested during the six months ended June 30, 2006 and 2005 was \$0.5 million and \$2.9 million, respectively.

Cash received from options exercised under our share-based payment arrangements was \$0.9 million and \$2.1 million for the three months ended June 30, 2006 and 2005, respectively. Cash received from options exercised under our share-based payment arrangements was \$0.9 million and \$6.1 million for the six months ended June 30, 2006 and 2005, respectively. The actual tax benefit realized for the tax deductions from option exercises of the share-based payment arrangements was immaterial for the three and six months ended June 30, 2006 and 2005.

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Pinnacle West has a current policy of issuing new shares to satisfy share requirements for stock compensation plans and does not expect to repurchase any shares during 2006.

**9. Variable-Interest Entities**

In 1986, APS entered into agreements with three separate VIE lessors in order to sell and lease back interests in Palo Verde Unit 2. The leases are accounted for as operating leases in accordance with GAAP. We are not the primary beneficiary of the Palo Verde VIEs and, accordingly, do not consolidate them.

APS is exposed to losses under the Palo Verde sale leaseback agreements upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the NRC issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to assume the debt associated with the transactions, make specified payments to the equity participants, and take title to the leased Unit 2 interests, which, if appropriate, may be required to be written down in value. If such an event had occurred as of June 30, 2006, APS would have been required to assume approximately \$228 million of debt and pay the equity participants approximately \$182 million.

**10. Derivative and Energy Trading Accounting**

We use derivative instruments (primarily forward purchases and sales, swaps, options and futures) to manage our exposure to the commodity price risk inherent in the purchase and sale of fuel, electricity and emission allowances and credits, as well as interest rate risk associated with long-term debt. As of June 30, 2006, we hedged exposures to the price variability of the power and gas commodities for a maximum of 3.25 years. The changes in market value of such contracts have a high correlation to price changes in the hedged transactions. In addition, subject to specified risk parameters monitored by the ERM, we engage in marketing and trading activities intended to profit from market price movements.

**Cash Flow Hedges**

The changes in the fair value of our hedged positions included in the Condensed Consolidated Statements of Income, after consideration of amounts deferred under the PSA, for the three and six months ended June 30, 2006 and 2005 are comprised of the following (dollars in thousands):

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Gains (losses) on the ineffective portion of derivatives qualifying for hedge accounting	\$ (2,975)	\$ 453	\$ (3,154)	\$ 7,777
Gains (losses) from the change in options' time value excluded from measurement of effectiveness	3	(119)	(14)	739
Gains from the discontinuance of cash flow hedges	--	--	434	385

During the next twelve months ending June 30, 2007, we estimate that a net gain of \$47 million before income taxes will be reclassified from accumulated OCI as an offset to the effect of market price changes for the related hedged transactions. To the extent the amounts are eligible for inclusion in the PSA, the amounts will be recorded as either a regulatory asset or liability and have no effect on earnings (see Note 5).

Our assets and liabilities from risk management and trading activities are presented in two categories, consistent with our business segments.

The following table summarizes our assets and liabilities from risk management and trading activities at June 30, 2006 and December 31, 2005 (dollars in thousands):

June 30, 2006

	Current Assets	Investments and Other Assets	Current Liabilities	Deferred Credits and Other	Net Asset (Liability)
Regulated electricity:					
Mark-to-market	\$ 330,793	\$ 192,384	\$ (329,666)	\$ (161,754)	\$ 31,757
Margin account and options	15,632	--	--	(1,114)	14,518
Marketing and trading:					
Mark-to-market	126,604	128,461	(55,085)	(81,018)	118,962
Options and emission allowances	522	286	(14,617)	--	(13,809)
Total	<u>\$ 473,551</u>	<u>\$ 321,131</u>	<u>\$ (399,368)</u>	<u>\$ (243,886)</u>	<u>\$ 151,428</u>

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2005

	Current Assets	Investments and Other Assets	Current Liabilities	Deferred Credits and Other	Net Asset (Liability)
Regulated electricity:					
Mark-to-market	\$ 516,399	\$ 228,873	\$ (335,801)	\$ (74,787)	\$ 334,684
Margin account and options	1,814	--	(124,165)	--	(122,351)
Marketing and trading:					
Mark-to-market	307,883	291,122	(236,922)	(181,417)	180,666
Options and emission allowances	1,683	77,836	(23,805)	(209)	55,505
Total	<u>\$ 827,779</u>	<u>\$ 597,831</u>	<u>\$ (720,693)</u>	<u>\$ (256,413)</u>	<u>\$ 448,504</u>

We maintain a margin account with a broker to support our risk management and trading activities. The margin account was an asset of \$13 million at June 30, 2006 and a liability of \$123 million at December 31, 2005 and is included in the margin account in the table above. Cash is deposited with the broker in this account at the time futures or options contracts are initiated. The change in market value of these contracts (reflected in mark-to-market) requires adjustment of the margin account balance.

Cash or other assets may be required to serve as collateral against our open positions on certain energy-related contracts. Collateral provided to counterparties was \$13 million at June 30, 2006 and \$6 million at December 31, 2005, and is included in other current assets on the Condensed Consolidated Balance Sheets. Collateral provided to us by counterparties was \$67 million at June 30, 2006 and \$216 million at December 31, 2005, and is included in other current liabilities on the Condensed Consolidated Balance Sheets.

#### **Credit Risk**

We are exposed to losses in the event of nonperformance or nonpayment by counterparties. We have risk management and trading contracts with many counterparties. Our risk management process assesses and monitors the financial exposure of all counterparties. Despite the fact that the great majority of trading counterparties' securities are rated as investment grade by the credit rating agencies, there is still a possibility that one or more of these companies could default, resulting in a material impact on consolidated earnings for a given period. Counterparties in the portfolio consist principally of financial institutions, major energy companies, municipalities and local distribution companies. We maintain credit policies that we believe minimize overall credit risk to within acceptable limits. Determination of the credit quality of our counterparties is based upon a number of factors, including credit ratings and our evaluation of their financial condition. To manage credit risk, we employ collateral requirements, standardized agreements that allow for the netting of positive and negative exposures associated with a single counterparty and credit default swaps. Valuation adjustments are established representing our estimated credit losses on our overall exposure to counterparties.



**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**11. Comprehensive Income (Loss)**

Components of comprehensive income (loss) for the three and six months ended June 30, 2006 and 2005 are as follows (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income	\$ 112,154	\$ 26,735	\$ 124,609	\$ 51,183
OCI (loss):				
Net unrealized gains (losses) on derivative instruments (a)	(69,124)	(24,220)	(274,107)	135,424
Reclassification of realized gain to income (b)	(676)	(9,769)	(18,206)	(15,688)
Income tax benefit (expense) related to items of OCI	27,257	13,334	114,149	(46,972)
Total OCI (loss)	(42,543)	(20,655)	(178,164)	72,764
Comprehensive income (loss)	\$ 69,611	\$ 6,080	\$ (53,555)	\$ 123,947

(a) These amounts primarily include unrealized gains and losses on contracts used to hedge our forecasted electricity and natural gas requirements to serve Native Load. These changes are primarily due to changes in forward natural gas prices and wholesale electricity prices.

(b) These amounts primarily include the reclassification of unrealized gains and losses to realized for contracted commodities delivered during the period.

**12. Commitments and Contingencies**

**Palo Verde Nuclear Generating Station**

**Spent Nuclear Fuel and Waste Disposal**

Nuclear power plant operators are required to enter into spent fuel disposal contracts with the DOE, and the DOE is required to accept and dispose of all spent nuclear fuel and other high-level radioactive wastes generated by domestic power reactors. Although the Nuclear Waste Policy Act required the DOE to develop a permanent repository for the storage and disposal of spent nuclear fuel by 1998, the DOE has announced that the repository cannot be completed before 2010 and it does not intend to begin accepting spent nuclear fuel prior to that date. In November 1997, the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit) issued a decision preventing the DOE from excusing its own delay, but refused to order the DOE to begin accepting spent nuclear fuel. Based on this decision and the DOE's delay, a number of utilities, including APS (on behalf of itself and the other Palo Verde owners), filed damages actions against the DOE in the Court of Federal Claims.

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

APS currently estimates it will incur \$147 million (in 2005 dollars) over the life of Palo Verde for its share of the costs related to the on-site interim storage of spent nuclear fuel. At June 30, 2006, APS had a regulatory asset of \$2 million that represents amounts spent for on-site interim spent fuel storage net of amounts recovered in rates per the ACC rate order that was effective April 1, 2005.

**California Energy Market Issues and Refunds in the Pacific Northwest**

**FERC**

In July 2001, the FERC ordered an expedited fact-finding hearing to calculate refunds for spot market transactions in California during a specified time frame. APS was a seller and a purchaser in the California markets at issue, and to the extent that refunds are ordered, APS should be a recipient as well as a payor of such amounts. The FERC is still considering the evidence and refund amounts have not yet been finalized. However, on September 6, 2005, the Ninth Circuit issued a decision, concluding that the FERC may not order refunds from entities that are not within the FERC's jurisdiction. Because a number of the entities owing refunds under the FERC's calculations are not within the FERC's jurisdiction, this order may affect the level of recovery of refunds due in this proceeding. In addition, on August 8, 2005, the FERC issued an order allowing sellers in the California markets to demonstrate that its refund methodology results in an overall revenue shortfall for their transactions in the relevant markets over a specified time frame. More than twenty sellers made such cost recovery filings on September 14, 2005. On January 26, 2006, the FERC conditionally accepted thirteen of these filings, reducing the refund liability for these sellers. Correspondingly, this will reduce the recovery of total refunds in the California markets. On August 2, 2006, the Ninth Circuit issued a decision on the appropriate temporal scope and the type of transactions properly subject to the refund orders. In the decision, the Court preserved the scope of the FERC's existing refund proceedings, but also expanded it potentially to include additional transactions, remanding the orders to the FERC for further proceedings. Petitions for rehearing on this order are due 90 days from the date of issuance. We currently believe the refund claims at FERC will have no material adverse impact on our financial position, results of operations, cash flow or liquidity.

On March 19, 2002, the State of California filed a complaint with the FERC alleging that wholesale sellers of power and energy, including the Company, failed to properly file rate information at the FERC in connection with sales to California from 2000 to the present under market-based rates. The complaint requests the FERC to require the wholesale sellers to refund any rates that are "found to exceed just and reasonable levels." This complaint was dismissed by the FERC and the State of California appealed the matter to the Ninth Circuit Court of Appeals. In an order issued September 9, 2004, the Ninth Circuit upheld the FERC's authority to permit market-based rates, but rejected the FERC's claim that it was without authority to consider retroactive refunds when a utility has not strictly adhered to the quarterly reporting requirements of the market-based rate system. On September 9, 2004, the Ninth Circuit remanded the case to the FERC for further proceedings. Several of the intervenors in this appeal filed a petition for rehearing of this decision on October 25, 2004. The petition for rehearing was denied on July 31, 2006. On August 4, 2006, the State of California filed a motion to stay the issuance of the mandate (scheduled to be issued on August 7, 2006), until the end of the period for seeking rehearing in the California refund

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

proceeding before the Ninth Circuit, discussed above. The outcome of the further proceedings cannot be predicted at this time.

The FERC also ordered an evidentiary proceeding to discuss and evaluate possible refunds for the Pacific Northwest. The FERC affirmed the ALJ's conclusion that the prices in the Pacific Northwest were not unreasonable or unjust and refunds should not be ordered in this proceeding. This decision has now been appealed to the Ninth Circuit Court of Appeals. Although the FERC ruling in the Pacific Northwest matter is being appealed and the FERC has not yet calculated the specific refund amounts due in California, we do not expect that the resolution of these issues, as to the amounts alleged in the proceedings, will have a material adverse impact on our financial position, results of operations or cash flows.

On March 26, 2003, the FERC made public a Final Report on Price Manipulation in Western Markets, prepared by its staff and covering spot markets in the West in 2000 and 2001. The report stated that a significant number of entities who participated in the California markets during the 2000-2001 time period, including APS, may potentially have been involved in arbitrage transactions that allegedly violated certain provisions of the Independent System Operator tariff. After reviewing the matter, along with the data supplied by APS, the FERC staff moved to dismiss the claims against APS and to dismiss the proceeding. The motion to dismiss was granted by the FERC on January 22, 2004. Certain parties have sought rehearing of this order, and that request is pending.

**FERC Order**

See "FERC Order" in Note 5 for a discussion of an order issued by the FERC on April 17, 2006.

**Natural Gas Supply**

Pursuant to the terms of a comprehensive settlement entered into in 1996 with El Paso Natural Gas Company, the rates charged for natural gas transportation were subject to a rate moratorium through December 31, 2005.

On July 9, 2003, the FERC issued an order that altered the capacity rights of parties to the 1996 settlement but maintained the cost responsibility provisions agreed to by parties to that settlement. On December 28, 2004, the D.C. Court of Appeals upheld the FERC's authority to alter the capacity rights of parties to the settlement. With respect to the FERC's authority to maintain the cost responsibility provisions of the settlement, a party has sought appellate review and is seeking to reallocate the cost responsibility associated with the changed contractual obligations in a way that would be less favorable to APS and Pinnacle West Energy than under the FERC's July 9, 2003 order. Should this party prevail on this point, APS and Pinnacle West Energy's annual capacity cost could be increased by approximately \$3 million per year after income taxes for the period September 2003 through December 2005. This appeal had been stayed pending further consideration by the FERC. On May 26, 2006, the FERC issued an Order on Remand affirming its earlier decision that there is no basis for modifying the settlement rates during the remaining term of the settlement. Despite the May 26 order, the party seeking appellate review is continuing to pursue an appeal of this issue.

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Consistent with its obligations under the 1996 settlement, El Paso filed a new rate case on June 30, 2005, which proposed new rates, terms and conditions and services to become effective on January 1, 2006. These rates are subject to refund pending the outcome of a hearing. The cost impact of this rate case will not have a material adverse effect on APS' financial position, results of operations, cash flows or liquidity.

**Navajo Nation Litigation**

In June 1999, the Navajo Nation served Salt River Project with a lawsuit filed in the United States District Court for the District of Columbia (the "D.C. Lawsuit") naming Salt River Project, several Peabody Coal Company entities (collectively, "Peabody"), Southern California Edison Company and other defendants, and citing various claims in connection with the renegotiations of the coal royalty and lease agreements under which Peabody mines coal for the Navajo Generating Station and the Mohave Generating Station. APS is a 14% owner of the Navajo Generating Station, which Salt River Project operates. The D.C. Lawsuit alleges, among other things, that the defendants obtained a favorable coal royalty rate by improperly influencing the outcome of a federal administrative process under which the royalty rate was to be adjusted. The suit seeks \$600 million in damages, treble damages, punitive damages of not less than \$1 billion, and the ejection of defendants "from all possessory interests and Navajo Tribal lands arising out of the [primary coal lease]." In July 2001, the court dismissed all claims against Salt River Project.

In January 2005, Peabody served APS with a lawsuit filed in the Circuit Court for the City of St. Louis naming APS and the other Navajo Generating Station participants and seeking, among other things, a declaration that the participants "are obligated to reimburse Peabody for any royalty, tax, or other obligation arising out of the D.C. Lawsuit." Based on APS' ownership interest in the Navajo Generating Station, APS could be liable for up to 14% of any such obligation. APS believes Peabody's claims are without merit and intends to contest those claims. Because the litigation is in preliminary stages, however, APS cannot currently predict the outcome of this matter.

**Superfund**

Superfund establishes liability for the cleanup of hazardous substances found contaminating the soil, water or air. Those who generated, transported or disposed of hazardous substances at a contaminated site are among those who are PRPs. PRPs may be strictly, and often jointly and severally, liable for clean-up. On September 3, 2003, the EPA advised APS that the EPA considers APS to be a PRP in the Motorola 52<sup>nd</sup> Street Superfund Site, Operable Unit 3 (OU3) in Phoenix, Arizona. APS has facilities that are within this superfund site. APS and Pinnacle West have agreed with the EPA to perform certain investigative activities of the APS facilities within OU3. Because the investigation has not yet been completed and ultimate remediation requirements are not yet finalized, neither APS nor Pinnacle West can currently estimate the expenditures which may be required.

**Income Taxes**

As a result of a change in IRS guidance, we claimed a tax deduction related to an APS tax accounting method change on the 2001 federal consolidated income tax return. The accelerated deduction resulted in a \$200 million reduction in the current income tax liability and a corresponding

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

increase in the plant-related deferred tax liability. In 2002, we received an income tax refund of approximately \$115 million related to our 2001 federal consolidated income tax return. The 2001 federal consolidated income tax return is currently under examination by the IRS. As part of this ongoing examination, the IRS is reviewing this accounting method change and the resultant deduction. During 2004 and again in 2005, the current income tax liability was increased, with a corresponding decrease to plant-related deferred tax liability, to reflect the expected outcome of this audit. We do not expect the ultimate outcome of this examination to have a material adverse impact on our financial position or results of operations. We expect that it will have a negative impact on cash flows.

**Litigation**

We are party to various other claims, legal actions and complaints arising in the ordinary course of business, including but not limited to environmental matters related to the Clean Air Act, Navajo Nation issues and EPA and ADEQ issues. In our opinion, the ultimate resolution of these matters will not have a material adverse effect on our financial position, results of operations, cash flows or liquidity.

**13. Nuclear Insurance**

The Palo Verde participants have insurance for public liability resulting from nuclear energy hazards to the full limit of liability under federal law. This potential liability is covered by primary liability insurance provided by commercial insurance carriers in the amount of \$300 million and the balance by an industry-wide retrospective assessment program. If losses at any nuclear power plant covered by the programs exceed the accumulated funds, APS could be assessed retrospective premium adjustments. The maximum assessment per reactor under the program for each nuclear incident is approximately \$101 million, subject to an annual limit of \$15 million per incident, to be periodically adjusted for inflation. Based on APS' interest in the three Palo Verde units, APS' maximum potential assessment per incident for all three units is approximately \$88 million, with an annual payment limitation of approximately \$13 million.

The Palo Verde participants maintain "all risk" (including nuclear hazards) insurance for property damage to, and decontamination of, property at Palo Verde in the aggregate amount of \$2.75 billion, a substantial portion of which must first be applied to stabilization and decontamination. APS has also secured insurance against portions of any increased cost of generation or purchased power and business interruption resulting from a sudden and unforeseen accidental outage of any of the three units. The property damage, decontamination, and replacement power coverages are provided by Nuclear Electric Insurance Limited (NEIL). APS is subject to retrospective assessments under all NEIL policies if NEIL's losses in any policy year exceed accumulated funds. The maximum amount of retrospective assessments APS could incur under the current NEIL policies totals \$17.8 million. The insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions and exclusions.

**14. Other Income and Other Expense**

The following table provides detail of other income and other expense for the three and six months ended June 30, 2006 and 2005 (dollars in thousands):

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Other income:				
Asset sales	\$ 8,810	\$ 142	\$ 9,171	\$ 383
Interest income	2,285	3,872	7,190	5,191
SunCor joint venture earnings	717	2,370	883	2,342
Investment gains – net (a)	--	923	--	--
Miscellaneous	210	1,377	245	1,571
Total other income	<u>\$ 12,022</u>	<u>\$ 8,684</u>	<u>\$ 17,489</u>	<u>\$ 9,487</u>
Other expense:				
Non-operating costs (b)	\$ (3,828)	\$ (3,058)	\$ (7,547)	\$ (6,156)
Investment losses – net (a)	(1,066)	--	(1,097)	(326)
Miscellaneous	(921)	(788)	(1,712)	(1,750)
Total other expense	<u>\$ (5,815)</u>	<u>\$ (3,846)</u>	<u>\$ (10,356)</u>	<u>\$ (8,232)</u>

(a) Includes joint venture and other non-operating income.

(b) As defined by the FERC, includes below-the-line non-operating utility costs (primarily community relations and other costs excluded from utility rate recovery).

**15. Guarantees**

We have issued parental guarantees and letters of credit and obtained surety bonds on behalf of APS Energy Services. Our credit support instruments enable APS Energy Services to offer commodity energy and energy-related products. Non-performance or non-payment under the original contract by APS Energy Services would require us to perform under the guarantee or surety bond. No liability is currently recorded on the Condensed Consolidated Balance Sheets related to Pinnacle West's current outstanding guarantees on behalf of its subsidiary. Our guarantees have no recourse or collateral provisions to allow us to recover amounts paid under the guarantees. At June 30, 2006, we had guarantees totaling \$21 million and surety bonds totaling \$24 million with a term of approximately one year for APS Energy Services.

At June 30, 2006, Pinnacle West had approximately \$4 million of letters of credit related to workers' compensation expiring in 2007. We intend to provide from either existing or new facilities for the extension, renewal or substitution of the letters of credit to the extent required.

APS has entered into various agreements that require letters of credit for financial assurance purposes. At June 30, 2006, approximately \$200 million of letters of credit were outstanding to support existing pollution control bonds of approximately \$200 million. The letters of credit are available to fund the payment of principal and interest of such debt obligations and expire in 2010. APS has also entered into approximately \$93 million of letters of credit to support certain equity lessors in the Palo Verde sale leaseback transactions (see Note 9 for further details on the Palo Verde sale leaseback transactions). These letters of credit expire in 2010. Additionally, at June 30, 2006 APS had approximately \$5 million of letters of credit related to counterparty collateral requirements.

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

expiring in 2006. APS intends to provide from either existing or new facilities for the extension, renewal or substitution of the letters of credit to the extent required.

We enter into agreements that include indemnification provisions relating to liabilities arising from or related to certain of our agreements. APS has agreed to indemnify the equity participants and other parties in the Palo Verde sale leaseback transactions with respect to certain tax matters. Generally, a maximum obligation is not explicitly stated in the indemnification provisions and, therefore, the overall maximum amount of the obligation under such indemnification provisions cannot be reasonably estimated. Based on historical experience and evaluation of the specific indemnities, we do not believe that any material loss related to such indemnification provisions is likely.

**16. Earnings Per Share**

The following table presents earnings per weighted average common share outstanding for the three and six months ended June 30, 2006 and 2005:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Basic earnings per share:				
Income from continuing operations	\$ 1.12	\$ 0.88	\$ 1.23	\$ 1.22
Income (loss) from discontinued operations	0.01	(0.60)	0.03	(0.68)
Earnings per share – basic	<u>\$ 1.13</u>	<u>\$ 0.28</u>	<u>\$ 1.26</u>	<u>\$ 0.54</u>
Diluted earnings per share:				
Income from continuing operations	\$ 1.11	\$ 0.88	\$ 1.23	\$ 1.22
Income (loss) from discontinued operations	0.02	(0.60)	0.02	(0.68)
Earnings per share – diluted	<u>\$ 1.13</u>	<u>\$ 0.28</u>	<u>\$ 1.25</u>	<u>\$ 0.54</u>

Dilutive stock options and performance shares increased average common shares outstanding by approximately 419,000 shares and 107,000 shares for the three months ended June 30, 2006 and 2005, respectively, and by approximately 394,000 shares and 100,000 shares for the six months ended June 30, 2006 and 2005, respectively.

Options to purchase 881,628 shares for the three-month period ended June 30, 2006 and 808,876 shares for the six-month period ended June 30, 2006 were outstanding but were not included in the computation of earnings per share because the options' exercise prices were greater than the average market price of the common shares. Options to purchase shares of common stock that were not included in the computation of diluted earnings per share for that same reason were 491,984 shares for the three-month period ended June 30, 2005 and 503,859 shares for the six-month period ended June 30, 2005.

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**17. Discontinued Operations**

**Silverhawk** (marketing and trading segment) – In June 2005, we entered into an agreement to sell our 75% interest in the Silverhawk Power Station to NPC. The sale was completed on January 10, 2006. As a result of this sale, we recorded a loss from discontinued operations of approximately \$56 million (\$91 million pretax) in the second quarter of 2005. The marketing and trading segment discontinued operations amounts in the chart below also include the revenues and expenses related to the operations of Silverhawk.

**SunCor** (real estate segment) – In 2005 and 2006, SunCor sold commercial properties that are required to be reported as discontinued operations on Pinnacle West's Condensed Consolidated Statements of Income in accordance with SFAS No. 144.

The following table provides revenue and income (loss) before income taxes and after income taxes classified as discontinued operations on Pinnacle West's Condensed Consolidated Statements of Income for the three and six months ended June 30, 2006 and 2005 (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenue:				
Silverhawk	\$ --	\$ 15	\$ 1	\$ 43
SunCor – commercial operations	2	3	3	7
Total revenue	<u>\$ 2</u>	<u>\$ 18</u>	<u>\$ 4</u>	<u>\$ 50</u>
Income (loss) before income taxes:				
Silverhawk (a)	\$ --	\$ (97)	\$ 1	\$ (107)
SunCor – commercial operations	2	1	3	3
Total income (loss) before income taxes	<u>\$ 2</u>	<u>\$ (96)</u>	<u>\$ 4</u>	<u>\$ (104)</u>
Income (loss) after income taxes:				
Silverhawk	\$ --	\$ (59)	\$ 1	\$ (65)
SunCor – commercial operations	1	1	2	1
Total income (loss) after income taxes	<u>\$ 1</u>	<u>\$ (58)</u>	<u>\$ 3</u>	<u>\$ (64)</u>

- (a) For the three and six months ended June 30, 2005, income (loss) before income taxes includes an interest expense allocation, net of capitalized costs, of \$3 million and \$6 million respectively. The allocation was based on Pinnacle West's weighted-average interest rate applied to the net property, plant and equipment.

**18. Nuclear Decommissioning Trust**

To fund the costs APS expects to incur to decommission Palo Verde, APS established external decommissioning trusts in accordance with NRC regulations. APS invests the trust funds in debt and domestic equity securities. APS applies the provisions of SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," in accounting for investments in



**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

decommissioning trust funds, and classifies these investments as available for sale. As a result, we record the decommissioning trust funds at their fair value on our Condensed Consolidated Balance Sheets. Because of the ability of APS to recover decommissioning costs in rates and in accordance with the regulatory treatment for decommissioning trust funds, APS has recorded the offsetting amount of unrealized gains (losses) on investment securities in other regulatory liabilities/assets. The following table summarizes the fair value of APS' nuclear decommissioning trust fund assets at June 30, 2006 and December 31, 2005 (dollars in millions):

	Fair Value	Total Unrealized Gains	Total Unrealized Losses
June 30, 2006			
Equity securities	\$ 160	\$ 53	\$ --
Debt securities	147	1	2
Total	<u>\$ 307</u>	<u>\$ 54</u>	<u>\$ 2</u>
December 31, 2005			
Equity securities	\$ 150	\$ 50	\$ --
Debt securities	144	3	1
Total	<u>\$ 294</u>	<u>\$ 53</u>	<u>\$ 1</u>

The costs of securities sold are determined on the basis of specific identification. The following table sets forth approximate gains and losses and proceeds from the sale of securities by the nuclear decommissioning trust funds (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Realized gains	\$ 1	\$ --	\$ 1	\$ 1
Realized losses	(1)	--	(2)	(1)
Proceeds from the sale of securities	49	43	115	83

The fair value of debt securities, summarized by contractual maturities, at June 30, 2006 is as follows (dollars in millions):

	Fair Value June 30, 2006
Less than one year	\$ 14
1 year - 5 years	32
5 years - 10 years	38
Greater than 10 years	63
Total	<u>\$ 147</u>

**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**19. New Accounting Standards**

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109." This guidance requires us to recognize the tax benefits of an uncertain tax position if it is more likely than not that the benefit will be sustained upon examination by the taxing authority. The Interpretation is effective for fiscal years beginning after December 15, 2006. We are currently evaluating this new guidance and believe it will not have a material impact on our financial statements.

**ARIZONA PUBLIC SERVICE COMPANY**  
**CONDENSED STATEMENTS OF INCOME**

(unaudited)  
(dollars in thousands)

	Three Months Ended June 30,	
	2006	2005
<b>ELECTRIC OPERATING REVENUES</b>		
Regulated electricity	\$ 714,727	\$ 581,757
Marketing and trading	4,123	7,000
Total	<u>718,850</u>	<u>588,757</u>
<b>OPERATING EXPENSES</b>		
Regulated electricity fuel and purchased power	265,735	201,871
Marketing and trading fuel and purchased power	1,490	3,349
Operations and maintenance	164,373	138,314
Depreciation and amortization	87,969	76,808
Income taxes	46,650	41,772
Other taxes	32,666	31,322
Total	<u>598,883</u>	<u>493,436</u>
<b>OPERATING INCOME</b>	<u>119,967</u>	<u>95,321</u>
<b>OTHER INCOME (DEDUCTIONS)</b>		
Income taxes	953	(1,549)
Allowance for equity funds used during construction	3,633	2,952
Other income (Note S-3)	10,989	7,005
Other expense (Note S-3)	(4,558)	(2,876)
Total	<u>11,017</u>	<u>5,532</u>
<b>INTEREST DEDUCTIONS</b>		
Interest on long-term debt	34,890	35,612
Interest on short-term borrowings	2,985	2,055
Debt discount, premium and expense	1,025	1,188
Allowance for borrowed funds used during construction	(1,673)	(2,000)
Total	<u>37,227</u>	<u>36,855</u>
<b>NET INCOME</b>	<u>\$ 93,757</u>	<u>\$ 63,998</u>

See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Financial Statements.

**ARIZONA PUBLIC SERVICE COMPANY**  
**CONDENSED STATEMENTS OF INCOME**

(unaudited)  
(dollars in thousands)

	Six Months Ended June 30,	
	2006	2005
<b>ELECTRIC OPERATING REVENUES</b>		
Regulated electricity	\$ 1,181,949	\$ 1,000,191
Marketing and trading	13,770	29,858
Total	<u>1,195,719</u>	<u>1,030,049</u>
<b>OPERATING EXPENSES</b>		
Regulated electricity fuel and purchased power	424,009	283,785
Marketing and trading fuel and purchased power	2,858	31,651
Operations and maintenance	337,726	280,608
Depreciation and amortization	174,280	159,022
Income taxes	43,621	58,152
Other taxes	68,214	62,767
Total	<u>1,050,708</u>	<u>875,985</u>
<b>OPERATING INCOME</b>	<u>145,011</u>	<u>154,064</u>
<b>OTHER INCOME (DEDUCTIONS)</b>		
Income taxes	1,189	(2,386)
Allowance for equity funds used during construction	7,434	5,555
Other income (Note S-3)	15,085	12,664
Other expense (Note S-3)	(7,528)	(6,234)
Total	<u>16,180</u>	<u>9,599</u>
<b>INTEREST DEDUCTIONS</b>		
Interest on long-term debt	69,140	71,129
Interest on short-term borrowings	5,011	3,246
Debt discount, premium and expense	2,198	2,192
Allowance for borrowed funds used during construction	(3,394)	(3,947)
Total	<u>72,955</u>	<u>72,620</u>
<b>NET INCOME</b>	<u>\$ 88,236</u>	<u>\$ 91,043</u>

See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Financial Statements.

**ARIZONA PUBLIC SERVICE COMPANY**  
**CONDENSED BALANCE SHEETS**

(unaudited)  
(dollars in thousands)

	June 30, 2006	December 31, 2005
<b>ASSETS</b>		
<b>UTILITY PLANT</b>		
Electric plant in service and held for future use	\$ 10,919,272	\$ 10,682,999
Less accumulated depreciation and amortization	3,718,938	3,616,886
Total	7,200,334	7,066,113
Construction work in progress	323,975	314,584
Intangible assets, net of accumulated amortization	100,932	90,327
Nuclear fuel, net of accumulated amortization	57,394	54,184
Utility plant – net	7,682,635	7,525,208
<b>INVESTMENTS AND OTHER ASSETS</b>		
Decommissioning trust accounts (Note 18)	306,981	293,943
Assets from long-term risk management and trading activities (Note S-1)	195,319	234,372
Other assets	64,654	64,128
Total investments and other assets	566,954	592,443
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	--	49,933
Customer and other receivables	441,811	421,621
Allowance for doubtful accounts	(3,438)	(3,568)
Materials and supplies (at average cost)	112,891	109,736
Fossil fuel (at average cost)	25,210	23,658
Assets from risk management and trading activities (Note S-1)	349,657	532,923
Deferred income taxes	3,364	--
Other current assets	18,012	14,639
Total current assets	947,507	1,148,942
<b>DEFERRED DEBITS</b>		
Deferred fuel and purchased power regulatory asset (Note 5)	174,666	172,756
Other regulatory assets	176,018	151,123
Unamortized debt issue costs	24,153	25,279
Other deferred debits	79,311	91,690
Total deferred debits	454,148	440,848
<b>TOTAL ASSETS</b>	<b>\$ 9,651,244</b>	<b>\$ 9,707,441</b>

See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Financial Statements.

**ARIZONA PUBLIC SERVICE COMPANY**  
**CONDENSED BALANCE SHEETS**  
(unaudited)  
(dollars in thousands)

	June 30, 2006	December 31, 2005
<b>CAPITALIZATION AND LIABILITIES</b>		
<b>CAPITALIZATION</b>		
Common stock	\$ 178,162	\$ 178,162
Additional paid-in capital (Note 5)	2,063,098	1,853,098
Retained earnings	863,911	860,675
Accumulated other comprehensive income (loss):		
Minimum pension liability adjustment	(86,132)	(86,132)
Derivative instruments	37,804	179,422
Common stock equity	3,056,843	2,985,225
Long-term debt less current maturities	2,479,214	2,479,703
Total capitalization	5,536,057	5,464,928
<b>CURRENT LIABILITIES</b>		
Commercial paper	117,558	--
Current maturities of long-term debt	84,829	85,620
Accounts payable	186,510	215,384
Accrued taxes	396,069	360,737
Accrued interest	25,657	25,003
Customer deposits	58,493	55,474
Deferred income taxes	--	64,210
Liabilities from risk management and trading activities (Note S-1)	336,372	480,138
Other current liabilities (Note S-1)	90,428	227,398
Total current liabilities	1,295,916	1,513,964
<b>DEFERRED CREDITS AND OTHER</b>		
Deferred income taxes	1,212,106	1,215,403
Regulatory liabilities	570,697	592,494
Liability for asset retirements	277,592	269,011
Pension liability	251,116	233,342
Customer advances for construction	63,704	60,287
Unamortized gain – sale of utility plant	43,469	45,757
Liabilities from long-term risk management and trading activities (Note S-1)	167,987	83,774
Other	232,600	228,481
Total deferred credits and other	2,819,271	2,728,549
<b>COMMITMENTS AND CONTINGENCIES (Notes 5, 12, 13, 15 and S-4)</b>		
<b>TOTAL CAPITALIZATION AND LIABILITIES</b>	<b>\$ 9,651,244</b>	<b>\$ 9,707,441</b>

See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Financial Statements.

**ARIZONA PUBLIC SERVICE COMPANY**  
**CONDENSED STATEMENTS OF CASH FLOWS**  
(unaudited)  
(dollars in thousands)

	Six Months Ended June 30,	
	2006	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 88,236	\$ 91,043
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization including nuclear fuel	186,225	162,641
Deferred fuel and purchased power	(94,565)	(33,785)
Deferred fuel and purchased power amortization	92,655	--
Allowance for equity funds used during construction	(7,434)	(5,555)
Deferred income taxes	16,481	(1,926)
Change in mark-to-market valuations	2,464	(12,191)
Changes in current assets and liabilities:		
Customer and other receivables	(13,257)	(12,223)
Materials, supplies and fossil fuel	(4,707)	(10,854)
Other current assets	1,677	2,566
Accounts payable	(26,765)	(61,798)
Accrued taxes	38,303	80,816
Collateral	(162,310)	84,071
Other current liabilities	25,063	(20,592)
Change in risk management and trading activities – liabilities	(120,505)	2,244
Change in other long-term assets	(5,045)	23,726
Change in other long-term liabilities	21,553	3,201
Net cash flow provided by operating activities	<u>38,069</u>	<u>291,384</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures	(313,479)	(301,098)
Allowance for borrowed funds used during construction	(3,394)	(3,947)
Purchase of Sundance Plant	--	(185,046)
Purchases of investment securities	(133,026)	(769,166)
Proceeds from sale of investment securities	133,026	677,558
Proceeds from nuclear decommissioning trust sales	114,875	82,764
Investment in nuclear decommissioning trust	(125,246)	(90,814)
Repayment of loan by Pinnacle West Energy	--	500,000
Other	(1,626)	(3,113)
Net cash flow used for investing activities	<u>(328,870)</u>	<u>(92,862)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Issuance of long-term debt	--	163,975
Repayment and reacquisition of long-term debt	(1,690)	(264,975)
Short-term borrowings, net	117,558	--
Equity infusion	210,000	100,000
Dividends paid on common stock	(85,000)	(42,500)
Net cash flow provided by (used for) financing activities	<u>240,868</u>	<u>(43,500)</u>
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<u>(49,933)</u>	<u>155,022</u>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<u>49,933</u>	<u>49,575</u>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<u>\$ --</u>	<u>\$ 204,597</u>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid (received) during the period for:		
Income taxes, net of refunds	\$ --	\$ (8,829)
Interest, net of amounts capitalized	\$ 70,103	\$ 73,656

See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Financial Statements.

Certain notes to APS' Condensed Financial Statements are combined with the Notes to Pinnacle West's Condensed Consolidated Financial Statements. Listed below are the Condensed Consolidated Notes to Pinnacle West's Condensed Consolidated Financial Statements, the majority of which also relate to APS' Condensed Financial Statements. In addition, listed below are the Supplemental Notes which are required disclosures for APS and should be read in conjunction with Pinnacle West's Condensed Consolidated Notes.

	Condensed Consolidated Footnote Reference	APS' Supplemental Footnote Reference
Consolidation and Nature of Operations	Note 1	--
Condensed Consolidated Financial Statements	Note 2	--
Quarterly Fluctuations	Note 3	--
Changes in Liquidity	Note 4	--
Regulatory Matters	Note 5	--
Retirement Plans and Other Benefits	Note 6	--
Business Segments	Note 7	--
Stock-Based Compensation	Note 8	--
Variable Interest Entities	Note 9	--
Derivative and Energy Trading Accounting	Note 10	Note S-1
Comprehensive Income	Note 11	Note S-2
Commitments and Contingencies	Note 12	--
Nuclear Insurance	Note 13	--
Other Income and Other Expense	Note 14	Note S-3
Guarantees	Note 15	--
Earnings Per Share	Note 16	--
Discontinued Operations	Note 17	--
Nuclear Decommissioning Trust	Note 18	--
New Accounting Standards	Note 19	--
Related Party Transactions	--	Note S-4



**ARIZONA PUBLIC SERVICE COMPANY**  
**SUPPLEMENTAL NOTES TO THE CONDENSED FINANCIAL STATEMENTS**

**S-1. Derivative and Energy Trading Accounting**

APS is exposed to the impact of market fluctuations in the commodity price of electricity, natural gas, coal and emissions allowances. As part of its overall risk management program, APS uses various commodity instruments that qualify as derivatives to hedge purchases and sales of electricity, fuels, and emission allowances and credits. As of June 30, 2006, APS hedged exposures to these risks for a maximum of 3.25 years.

**Cash Flow Hedges**

The changes in the fair value of APS' hedged positions included in the APS Condensed Statements of Income, after consideration of amounts deferred under the PSA, for the three and six months ended June 30, 2006 and 2005 were comprised of the following (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Gains (losses) on the ineffective portion of derivatives qualifying for hedge accounting	\$ (2,824)	\$ 451	\$ (3,260)	\$ 7,868
Gains (losses) from the change in options' time value excluded from measurement of effectiveness	3	(119)	(14)	739
Gains from the discontinuance of cash flow hedges	--	--	159	302

During the next twelve months ending June 30, 2007, APS estimates that a net gain of \$15 million before income taxes will be reclassified from accumulated OCI as an offset to the effect of market price changes for the related hedged transactions. To the extent the amounts are eligible for inclusion in the PSA, the amounts will be recorded as either a regulatory asset or liability and have no effect on earnings (see Note 5).

APS' assets and liabilities from risk management and trading activities are presented in two categories, consistent with Pinnacle West's business segments.

The following table summarizes APS' assets and liabilities from risk management and trading activities at June 30, 2006 and December 31, 2005 (dollars in thousands):

**ARIZONA PUBLIC SERVICE COMPANY**  
**SUPPLEMENTAL NOTES TO THE CONDENSED FINANCIAL STATEMENTS**

June 30, 2006

	Current Assets	Investments and Other Assets	Current Liabilities	Deferred Credits and Other	Net Asset (Liability)
Regulated Electricity:					
Mark-to-market	\$ 330,793	\$ 192,384	\$ (329,666)	\$ (161,754)	\$ 31,757
Margin account and options	15,632	--	--	(1,114)	14,518
Marketing and Trading:					
Mark-to-market	3,232	2,935	(3,951)	(5,119)	(2,903)
Options	--	--	(2,755)	--	(2,755)
Total	<u>\$ 349,657</u>	<u>\$ 195,319</u>	<u>\$ (336,372)</u>	<u>\$ (167,987)</u>	<u>\$ 40,617</u>

December 31, 2005

	Current Assets	Investments and Other Assets	Current Liabilities	Deferred Credits and Other	Net Asset (Liability)
Regulated Electricity:					
Mark-to-market	\$ 516,399	\$ 228,873	\$ (335,801)	\$ (74,787)	\$ 334,684
Margin account and options	1,814	--	(124,165)	--	(122,351)
Marketing and Trading:					
Mark-to-market	13,027	5,499	(20,172)	(8,778)	(10,424)
Options	1,683	--	--	(209)	1,474
Total	<u>\$ 532,923</u>	<u>\$ 234,372</u>	<u>\$ (480,138)</u>	<u>\$ (83,774)</u>	<u>\$ 203,383</u>

We maintain a margin account with a broker to support our risk management and trading activities. The margin account was an asset of \$13 million at June 30, 2006 and a liability of \$123 million at December 31, 2005 and is included in the margin account in the table above. Cash is deposited with the broker in this account at the time futures or options contracts are initiated. The change in market value of these contracts (reflected in mark-to-market) requires adjustment of the margin account balance.

Cash or other assets may be required to serve as collateral against APS' open positions on certain energy-related contracts. Collateral provided to counterparties was \$4 million at June 30, 2006 and is included in other current assets on the Condensed Balance Sheets. No collateral was provided at December 31, 2005. Collateral provided to us by counterparties was \$16 million at June 30, 2006 and \$175 million at December 31, 2005, and is included in other current liabilities on the Condensed Balance Sheets.

**S-2. Comprehensive Income (Loss)**

Components of APS' comprehensive income (loss) for the three and six months ended June 30, 2006 and 2005 are as follows (dollars in thousands):

**ARIZONA PUBLIC SERVICE COMPANY**  
**SUPPLEMENTAL NOTES TO THE CONDENSED FINANCIAL STATEMENTS**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income	\$ 93,757	\$ 63,998	\$ 88,236	\$ 91,043
OCI (loss):				
Unrealized gains (losses) on derivative instruments (a)	(62,304)	(24,147)	(225,196)	84,070
Reclassification of realized (gains) losses to income (b)	2,958	(4,437)	(7,157)	(5,819)
Income tax (expense) benefit related to items of OCI	23,175	11,253	90,735	(30,807)
Total OCI (loss)	(36,171)	(17,331)	(141,618)	47,444
Comprehensive income (loss)	<u>\$ 57,586</u>	<u>\$ 46,667</u>	<u>\$ (53,382)</u>	<u>\$ 138,487</u>

- (a) These amounts primarily include unrealized gains and losses on contracts used to hedge our forecasted electricity and natural gas requirements to serve Native Load. These changes are primarily due to changes in forward natural gas prices and wholesale electricity prices.
- (b) These amounts primarily include the reclassification of unrealized gains and losses to realized gains and losses for contracted commodities delivered during the period.

**S-3. Other Income and Other Expense**

The following table provides detail of APS' other income and other expense for the three and six months ended June 30, 2006 and 2005 (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Other income:				
Asset sales	\$ 8,810	\$ 142	\$ 9,171	\$ 383
Interest income	1,970	4,177	5,504	9,600
Investment gains – net	--	981	165	479
Miscellaneous	209	1,705	245	2,202
Total other income	<u>\$ 10,989</u>	<u>\$ 7,005</u>	<u>\$ 15,085</u>	<u>\$ 12,664</u>
Other expense:				
Non-operating costs(a)	\$ (3,311)	\$ (2,708)	\$ (6,527)	\$ (5,335)
Investment losses – net	(710)	--	--	--
Miscellaneous	(537)	(168)	(1,001)	(899)
Total other expense	<u>\$ (4,558)</u>	<u>\$ (2,876)</u>	<u>\$ (7,528)</u>	<u>\$ (6,234)</u>

- (a) As defined by the FERC, includes below-the-line non-operating utility costs (primarily community relations and other costs excluded from utility rate recovery).

**ARIZONA PUBLIC SERVICE COMPANY**  
**SUPPLEMENTAL NOTES TO THE CONDENSED FINANCIAL STATEMENTS**

**S-4. Related Party Transactions**

From time to time, APS enters into transactions with Pinnacle West or Pinnacle West's other subsidiaries. The following table summarizes the amounts included in the APS Condensed Statements of Income and Condensed Balance Sheets related to transactions with affiliated companies (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Electric operating revenues:				
Pinnacle West – marketing and trading	\$ 2	\$ 2	\$ 3	\$ 3
Pinnacle West Energy	--	1	--	2
Total	<u>\$ 2</u>	<u>\$ 3</u>	<u>\$ 3</u>	<u>\$ 5</u>
Fuel and purchased power costs:				
Pinnacle West Energy	\$ --	\$ 39	\$ --	\$ 47
Other:				
Pinnacle West Energy interest income	\$ --	\$ --	\$ --	\$ 5
	As of June 30, 2006		As of December 31, 2005	
Net intercompany receivables (payables):				
Pinnacle West – marketing and trading	\$ 13		\$ 82	
APS Energy Services	1		2	
Pinnacle West	(19)		(2)	
Total	<u>\$ (5)</u>		<u>\$ 82</u>	

Electric revenues include sales of electricity to affiliated companies at contract prices. Purchased power includes purchases of electricity from affiliated companies at contract prices. APS purchases electricity from and sells electricity to APS Energy Services; however, these transactions are settled net and reported net in accordance with EITF 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not 'Held for Trading Purposes' As Defined in EITF Issue No. 02-3."

Intercompany receivables primarily include amounts related to the intercompany sales of electricity. Intercompany payables primarily include amounts related to the intercompany purchases of electricity. Intercompany receivables and payables are generally settled on a current basis in cash.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **INTRODUCTION**

The following discussion should be read in conjunction with Pinnacle West's Condensed Consolidated Financial Statements and Arizona Public Service Company's Condensed Financial Statements and the related Notes that appear in Item 1 of this report.

### **OVERVIEW**

Pinnacle West owns all of the outstanding common stock of APS. APS is a vertically-integrated electric utility that provides retail and wholesale electric service to most of the state of Arizona, with the major exceptions of about one-half of the Phoenix metropolitan area, the Tucson metropolitan area and Mohave County in northwestern Arizona. APS has historically accounted for a substantial part of our revenues and earnings, and is expected to continue to do so. Customer growth in APS' service territory is about three times the national average and remains a fundamental driver of our revenues and earnings.

The ACC regulates APS' retail electric rates. The key issue affecting Pinnacle West's and APS' financial outlook is the satisfactory resolution of APS' retail rate proceedings pending before the ACC. As discussed in greater detail in Note 5, these proceedings consist of:

- a general retail rate case pursuant to which APS is requesting a 21.3%, or \$453.9 million, increase in its annual retail electricity revenues effective no later than December 31, 2006;
- an application for a temporary rate increase of approximately 1.9%, through a PSA surcharge, to recover \$45 million in retail fuel and purchased power costs relating to Palo Verde's 2005 unplanned outages that were deferred by APS in 2005 under the PSA and are subject to the ACC's completion of an inquiry regarding the outages; and
- the ACC's prudence review of amounts collected through the May 2, 2006 interim PSA adjuster (see "Interim Rate Increase" in Note 5) related to unplanned 2006 Palo Verde outages. The related PSA deferrals were approximately \$70 million for the six months ended June 30, 2006.

SunCor, our real estate development subsidiary, has been and is expected to be an important source of earnings and cash flow. Our subsidiary, APS Energy Services, provides competitive commodity-related energy services and energy-related products and services to commercial and industrial retail customers in the western United States. El Dorado, our investment subsidiary, owns minority interests in several energy-related investments and Arizona community-based ventures.

Pinnacle West Energy is our subsidiary that previously owned and operated unregulated generating plants. Pursuant to the ACC's April 7, 2005 order in APS' 2003 rate case, on July 29, 2005, Pinnacle West Energy transferred the PWEC Dedicated Assets to APS. See "APS 2003 Rate Case" in Note 5. Pinnacle West Energy sold its 75% interest in Silverhawk to NPC on January 10, 2006. See Note 17 for discussion of discontinued operations. As a result, Pinnacle West Energy no longer owns any generating plants and has ceased operations.

We continue to focus on solid operational performance in our electricity generation and delivery activities. In the delivery area, we focus on superior reliability and customer satisfaction. We plan to expand long-term resources and our transmission and distribution systems to meet the electricity needs of our growing retail customers and sustain reliability.

See "Pinnacle West Consolidated – Factors Affecting Our Financial Outlook" below for a discussion of several factors that could affect our future financial results.

### EARNINGS CONTRIBUTION BY BUSINESS SEGMENT

Pinnacle West has three principal business segments (determined by products, services and the regulatory environment):

- our regulated electricity segment, which consists of traditional regulated retail and wholesale electricity businesses (primarily electric service to Native Load customers) and related activities and includes electricity generation, transmission and distribution;
- our real estate segment, which consists of SunCor's real estate development and investment activities; and
- our marketing and trading segment, which consists of our competitive energy business activities, including wholesale marketing and trading and APS Energy Services' commodity-related energy services.

The following table summarizes net income by segment for the three months and six months ended June 30, 2006 and 2005 (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Regulated electricity	\$ 95	\$ 69	\$ 82	\$ 83
Real estate	8	11	30	19
Marketing and trading	7	4	9	11
Other	1	1	1	2
Income from continuing operations	111	85	122	115
Discontinued operations – net of tax:				
Real estate (a)	1	1	2	1
Marketing and trading (b)	-	(59)	1	(65)
Net income	\$ 112	\$ 27	\$ 125	\$ 51

(a) Primarily relates to sales of commercial properties.

(b) Relates to the loss on the sale of Silverhawk in June 2005 and the operations of Silverhawk.

## PINNACLE WEST CONSOLIDATED – RESULTS OF OPERATIONS

### General

Throughout the following explanations of our results of operations, we refer to “gross margin.” With respect to our regulated electricity segment and our marketing and trading segment, gross margin refers to operating revenues less fuel and purchased power costs. “Gross margin” is a “non-GAAP financial measure,” as defined in accordance with SEC rules. Exhibit 99.1 reconciles this non-GAAP financial measure to operating income, which is the most directly comparable financial measure calculated and presented in accordance with accounting principles generally accepted in the United States (GAAP). We view gross margin as an important performance measure of the core profitability of our operations. This measure is a key component of our internal financial reporting and is used by our management in analyzing our business segments. We believe that investors benefit from having access to the same financial measures that our management uses. In addition, we have reclassified certain prior-period amounts to conform to our current-period presentation.

### Deferred Fuel and Purchased Power Costs

APS’ retail rate settlement became effective April 1, 2005. As part of the settlement, the ACC approved the PSA, which permits APS to defer for recovery or refund fluctuations in retail fuel and purchased power costs, subject to specified parameters. In accordance with the PSA, APS defers for future rate recovery 90% of the difference between actual retail fuel and purchased power costs and the amount of such costs currently included in base rates. APS’ recovery of PSA deferrals from its customers is subject to the ACC’s approval of annual PSA adjustments and periodic surcharge applications. See “Power Supply Adjustor” in Note 5.

Since the inception of the PSA, APS has incurred substantially higher fuel and purchased power prices than those authorized in APS’ current base rates and has deferred those cost differences in accordance with the PSA. The balance of APS’ PSA deferrals at June 30, 2006 was \$175 million. APS estimates that its PSA deferral balance at December 31, 2006 will be approximately \$155 million to \$175 million, based on APS’ hedged positions for fuel and purchased power at June 30, 2006 and recent forward market prices for natural gas and purchased power (which are subject to change). The recovery of PSA deferrals through ACC approved adjustors and surcharges recorded as revenue is offset dollar-for-dollar by the amortization of those deferred expenses.

APS operated Palo Verde Unit 1 at reduced power levels from December 25, 2005 until March 18, 2006 due to vibration levels in one of the Unit’s shutdown cooling lines. During an outage at Unit 1 from March 18, 2006 to July 7, 2006, APS performed the necessary work and modifications to remedy the situation. APS estimates that incremental replacement power costs resulting from Palo Verde’s outages and reduced power levels were approximately \$78 million during the six months ended June 30, 2006. The related PSA deferrals were approximately \$70 million in that period. The Palo Verde replacement power costs were partially offset by \$30 million of lower than expected replacement power costs related to APS’ fossil-fueled generating units during the six months ended June 30, 2006. As a result, the corresponding deferrals were reduced in that six-month period by \$27 million.

The PSA deferral balance at June 30, 2006 and estimated balance as of December 31, 2006 each includes (a) \$45 million related to replacement power costs associated with unplanned 2005

Palo Verde outages and (b) \$70 million related to replacement power costs associated with unplanned 2006 outages or reduced power operations at Palo Verde. The PSA deferrals associated with these unplanned Palo Verde outages and reduced power operations are the subject of ACC prudence reviews. See "PSA Deferrals Related to Unplanned Palo Verde Outages" in Note 5.

**Operating Results – Three-month period ended June 30, 2006 compared with three-month period ended June 30, 2005**

Our consolidated net income for the three months ended June 30, 2006 was \$112 million compared with \$27 million for the comparable prior-year period. The three months ended June 30, 2005 included a net loss from discontinued operations of \$58 million, substantially all of which was related to the sale and operations of Silverhawk. Income from continuing operations increased \$26 million in the period-to-period comparison, reflecting the following changes in earnings by segment:

- **Regulated Electricity Segment** – Income from continuing operations increased approximately \$26 million primarily due to higher retail sales volumes related to customer growth; effects of warmer weather on retail sales; income tax credits related to prior years resolved in 2006; and lower interest expense. These positive factors were partially offset by higher operations and maintenance expense related to generation and customer service. Higher fuel and purchased power costs (as discussed above) were substantially offset by the deferral of those costs in accordance with the PSA.
- **Real Estate Segment** – Income from continuing operations decreased approximately \$3 million primarily due to decreased margins on parcel sales, partially offset by increased margins on residential sales.
- **Marketing and Trading Segment** – Income from continuing operations increased approximately \$3 million primarily due to higher unit margins on wholesale sales.



Additional details on the major factors that increased (decreased) net income are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Regulated electricity segment gross margin:		
Higher fuel and purchased power costs	\$ (43)	\$ (26)
Increased deferred fuel and purchased power costs	40	24
Higher retail sales volumes due to customer growth, excluding weather effects	26	16
Effects of warmer weather on retail sales	16	10
Miscellaneous items, net	(9)	(6)
Net increase in regulated electricity segment gross margin	30	18
Higher marketing and trading segment gross margin primarily due to higher unit margins on wholesale sales	3	2
Lower real estate segment contribution primarily related to decreased margins on parcel sales, partially offset by increased margins on residential sales	(5)	(3)
Operations and maintenance increases primarily due to:		
Generation costs, including maintenance and overhauls	(6)	(4)
Customer service costs, including regulatory demand-side management programs and planned maintenance	(4)	(2)
Miscellaneous items, net	(5)	(3)
Lower interest expense, net of capitalized financing costs, primarily due to lower debt balances, partially offset by higher rates	6	4
Income tax credits related to prior years resolved in 2006	--	10
Miscellaneous items, net	1	4
Net increase in income from continuing operations	\$ 20	26
Discontinued operations related to the sale of Silverhawk		59
Net increase in net income		\$ 85

### Regulated Electricity Segment Revenues

Regulated electricity segment revenues were \$133 million higher for the three months ended June 30, 2006 compared with the prior-year period primarily as a result of:

- a \$75 million increase in revenues related to recovery of PSA deferrals, which had no earnings effect because of amortization of the same amount recorded as fuel and purchased power expense (see "Deferred Fuel and Purchased Power Costs" above);
- a \$36 million increase in retail revenues related to customer growth, excluding weather effects;
- a \$22 million increase in retail revenues related to warmer weather;
- a \$10 million increase in Off-System Sales due to higher prices; and
- a \$10 million decrease due to miscellaneous factors.

### **Real Estate Segment Revenues**

Real estate segment revenues were \$28 million higher for the three months ended June 30, 2006 compared with the prior-year period primarily as a result of:

- a \$32 million increase from residential sales due to higher prices and volumes;
- an \$11 million decrease from parcel sales due to timing; and
- a \$7 million increase due to miscellaneous sales.

### **Marketing and Trading Segment Revenues**

Marketing and trading segment revenues were \$19 million higher for the three months ended June 30, 2006 compared with the prior-year period primarily as a result of:

- a \$12 million increase due to higher power prices on delivered wholesale electricity sales;
- a \$10 million increase from higher prices on competitive retail sales in California; and
- a \$3 million decrease in mark-to-market gains on contracts for future delivery due to changes in forward prices.

### **Operating Results – Six-month period ended June 30, 2006 compared with six-month period ended June 30, 2005**

Our consolidated net income for the six months ended June 30, 2006 was \$125 million compared with \$51 million for the comparable prior-year period. The six months ended June 30, 2005 included a net loss from discontinued operations of \$64 million, substantially all of which was related to the sale and operations of Silverhawk. Income from continuing operations increased \$7 million in the period-to-period comparison, reflecting the following changes in earnings by segment:

- Regulated Electricity Segment – Income from continuing operations decreased approximately \$1 million primarily due to higher fuel and purchased power costs (as discussed above); and higher operations and maintenance expense related to generation and customer service. These negative factors were partially offset by deferred fuel and purchased power costs; higher retail sales volumes due to customer growth; income tax credits related to prior years resolved in 2006; effects of weather on retail sales; a retail price increase effective April 1, 2005; lower interest expense; and higher interest income.
- Real Estate Segment – Income from continuing operations increased approximately \$11 million primarily due to increased margins on residential and parcel sales.
- Marketing and Trading Segment – Income from continuing operations decreased approximately \$2 million primarily due to lower mark-to-market gains on contracts for future delivery, partially offset by higher unit margins on wholesale sales.

Additional details on the major factors that increased (decreased) net income are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Regulated electricity segment gross margin:		
Higher fuel and purchased power costs	\$ (98)	\$ (60)
Increased deferred fuel and purchased power costs (deferrals began April 1, 2005)	53	32
Higher retail sales volumes due to customer growth, excluding weather effects	39	24
Effects of weather on retail sales	13	8
Retail price increase effective April 1, 2005	7	4
Miscellaneous items, net	(13)	(7)
Net increase in regulated electricity segment gross margin	1	1
Lower marketing and trading segment gross margin primarily related to lower mark-to-market gains, partially offset by higher unit margins on wholesale sales	(4)	(2)
Higher real estate segment contribution primarily related to increased margins on residential and parcel sales	18	11
Operations and maintenance increases primarily due to:		
Generation costs, including maintenance and overhauls	(28)	(17)
Customer service costs, including regulatory demand-side management programs and planned maintenance	(11)	(7)
Lower interest expense, net of capitalized financing costs, primarily due to lower debt balances, partially offset by higher rates	7	4
Higher other income, net of expense, primarily due to miscellaneous asset sales and increased interest income	6	4
Income tax credits related to prior years resolved in 2006	--	10
Miscellaneous items, net	1	3
Net increase (decrease) in income from continuing operations	\$ (10)	7
Discontinued operations related to the sale of Silverhawk and sales of real estate assets		67
Net increase in net income		\$ 74

### Regulated Electricity Segment Revenues

Regulated electricity segment revenues were \$183 million higher for the six months ended June 30, 2006 compared with the prior-year period primarily as a result of:

- a \$93 million increase in revenues related to recovery of PSA deferrals, which had no earnings effect because of amortization of the same amount recorded as fuel and purchased power expense (see "Deferred Fuel and Purchased Power Costs" above);
- a \$54 million increase in retail revenues related to customer growth, excluding weather effects;

- an \$18 million increase in retail revenues related to weather;
- a \$12 million increase in Off-System Sales primarily resulting from sales previously reported in the marketing and trading segment that were classified beginning in April 2005 as sales in the regulated electricity segment in accordance with the APS retail rate case settlement;
- a \$10 million increase in Off-System Sales due to higher prices;
- a \$7 million increase in retail revenues due to a price increase effective April 1, 2005; and
- an \$11 million decrease due to miscellaneous factors.

#### **Real Estate Segment Revenues**

Real estate segment revenues were \$66 million higher for the six months ended June 30, 2006 compared with the prior-year period primarily as a result of:

- a \$48 million increase from residential sales due to higher prices and volumes;
- a \$9 million increase from parcel sales due to timing; and
- a \$9 million increase due to miscellaneous sales.

#### **Marketing and Trading Segment Revenues**

Marketing and trading segment revenues were \$15 million higher for the six months ended June 30, 2006 compared with the prior-year period primarily as a result of:

- a \$32 million increase from higher prices on competitive retail sales in California;
- a \$12 million decrease in off-system sales due to the absence of sales previously reported in the marketing and trading segment that were classified beginning in April 2005 as sales in the regulated electricity segment in accordance with the APS retail rate case settlement;
- a \$7 million decrease in mark-to-market gains on contracts for future delivery due to changes in forward prices; and
- a \$2 million increase due to miscellaneous factors.

## LIQUIDITY AND CAPITAL RESOURCES

### Capital Needs and Resources – Pinnacle West Consolidated

#### Capital Expenditure Requirements

The following table summarizes the actual capital expenditures for the six months ended June 30, 2006 and estimated capital expenditures for the next three years:

<b>CAPITAL EXPENDITURES</b> (dollars in millions)				
	Six Months Ended June 30,	Estimated for the Year Ended December 31,		
	2006	2006	2007	2008
APS				
Distribution	\$ 184	\$ 322	\$ 323	\$ 362
Transmission	55	120	169	203
Generation	73	184	207	279
Other (a)	10	23	16	13
Subtotal	322	649	715	857
SunCor (b)	100	232	142	119
Other	5	6	2	6
Total	<u>\$ 427</u>	<u>\$ 887</u>	<u>\$ 859</u>	<u>\$ 982</u>

(a) Primarily information systems and facilities projects.

(b) Consists primarily of capital expenditures for land development and retail and office building construction reflected in "Real estate investments" and "Capital expenditures" on the Condensed Consolidated Statements of Cash Flows.

Distribution and transmission capital expenditures are comprised of infrastructure additions and upgrades, capital replacements, new customer construction and related information systems and facility costs. Examples of the types of projects included in the forecast include lines, substations, line extensions to new residential and commercial developments and upgrades to customer information systems. Major transmission projects are driven by strong regional customer growth.

Generation capital expenditures are comprised of various improvements to APS' existing fossil and nuclear plants and the replacement of Palo Verde steam generators (see below). Examples of the types of projects included in this category are additions, upgrades and capital replacements of various power plant equipment such as turbines, boilers and environmental equipment. Generation also includes nuclear fuel expenditures of approximately \$35 million annually for 2006 through 2008.

The Palo Verde owners have approved the manufacture of one additional set of steam generators. These generators will be installed in Unit 3 and are scheduled for completion in the fall of 2007 at an approximate cost of \$75 million (APS' share). Approximately \$25 million of the Unit

3 steam generator costs have been incurred through June 30, 2006, with the remaining \$50 million included in the capital expenditures table above. Capital expenditures will be funded with internally generated cash and/or external financings.

### Contractual Obligations

Our future contractual obligations have not changed materially from the amounts disclosed in Part II, Item 7 of the 2005 Form 10-K, with the exception of our aggregate:

- fuel and purchased power commitments, which increased from approximately \$1.9 billion at December 31, 2005 to \$2.9 billion at June 30, 2006 as follows (in billions):

2006	2007-2008	2009-2010	Thereafter	Total
\$0.5	\$0.6	\$0.4	\$1.4	\$2.9

See Note 4 for a list of payments due on total long-term debt and capitalized lease requirements.

### Off-Balance Sheet Arrangements

In 1986, APS entered into agreements with three separate VIE lessors in order to sell and lease back interests in Palo Verde Unit 2. The leases are accounted for as operating leases in accordance with GAAP. We are not the primary beneficiary of the Palo Verde VIEs and, accordingly, do not consolidate them.

APS is exposed to losses under the Palo Verde sale leaseback agreements upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the NRC issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to assume the debt associated with the transactions, make specified payments to the equity participants, and take title to the leased Unit 2 interests, which, if appropriate, may be required to be written down in value. If such an event had occurred as of June 30, 2006, APS would have been required to assume approximately \$228 million of debt and pay the equity participants approximately \$182 million.

### Guarantees and Letters of Credit

We have issued guarantees and letters of credit in support of our unregulated businesses. We have also obtained surety bonds on behalf of APS Energy Services. We have not recorded any liability on our Condensed Consolidated Balance Sheets with respect to these obligations. We generally agree to indemnification provisions related to liabilities arising from or related to certain of our agreements, with limited exceptions depending on the particular agreement. See Note 15 for additional information regarding guarantees and letters of credit.

### Credit Ratings

The ratings of securities of Pinnacle West and APS as of August 7, 2006 are shown below. The ratings reflect the respective views of the rating agencies, from which an explanation of the significance of their ratings may be obtained. There is no assurance that these ratings will continue for any given period of time. The ratings may be revised or withdrawn entirely by the rating

agencies, if, in their respective judgments, circumstances so warrant. Any downward revision or withdrawal may adversely affect the market price of Pinnacle West's or APS' securities and serve to increase the cost of and access to capital. It may also require additional collateral related to certain derivative instruments (see Note 10).

	Moody's	Standard & Poor's
<b>Pinnacle West</b>		
Senior unsecured <sup>(a)</sup>	Baa3 (P)	BB+ (prelim)
Commercial paper	P-3	A-3
Outlook	Negative	Stable
<b>APS</b>		
Senior unsecured	Baa2	BBB-
Secured lease obligation bonds	Baa2	BBB-
Commercial paper	P-2	A-3
Outlook	Negative	Stable

<sup>(a)</sup>Pinnacle West has a combined shelf registration under SEC Rule 415. Moody's assigns a provisional (P) rating and Standard & Poor's assigns a preliminary (prelim) rating to such shelf registrations. Pinnacle West currently has no outstanding, rated senior unsecured securities.

#### Debt Provisions

Pinnacle West's and APS' debt covenants related to their respective bank financing arrangements include a debt to capitalization ratio. Certain of APS' bank financing arrangements also include an interest coverage test. Pinnacle West and APS comply with these covenants and each anticipates it will continue to meet these and other significant covenant requirements. For each of Pinnacle West and APS, these covenants require that the ratio of consolidated debt to total consolidated capitalization cannot exceed 65%. At June 30, 2006, the ratio was approximately 48% for Pinnacle West and 46% for APS. The provisions regarding interest coverage require a minimum cash coverage of two times the interest requirements for APS. The interest coverage was approximately 4 times under APS' bank financing agreements as of June 30, 2006. Failure to comply with such covenant levels would result in an event of default which, generally speaking, would require the immediate repayment of the debt subject to the covenants and could cross-default other debt.

Neither Pinnacle West's nor APS' financing agreements contain "rating triggers" that would result in an acceleration of the required interest and principal payments in the event of a rating downgrade. However, in the event of a further rating downgrade, Pinnacle West and/or APS may be subject to increased interest costs under certain financing agreements.

All of Pinnacle West's bank agreements contain "cross-default" provisions that would result in defaults and the potential acceleration of payment under these loan agreements if Pinnacle West or APS were to default under certain other material agreements. All of APS' bank agreements contain cross-default provisions that would result in defaults and the potential acceleration of payment under these bank agreements if APS were to default under certain other material agreements. Pinnacle West and APS do not have a material adverse change restriction for revolver borrowings.

See Note 4 for further discussions.

### **Capital Needs and Resources - By Company**

#### **Pinnacle West (Parent Company)**

Our primary cash needs are for dividends to our shareholders and principal and interest payments on our long-term debt. The level of our common stock dividends and future dividend growth will be dependent on a number of factors including, but not limited to, payout ratio trends, free cash flow and financial market conditions.

Our primary sources of cash are dividends from APS, external financings and cash distributions from our other subsidiaries, primarily SunCor. An existing ACC order requires APS to maintain a common equity ratio of at least 40% and prohibits APS from paying common stock dividends if the payment would reduce its common equity below that threshold. As defined in the ACC order, the common equity ratio is common equity divided by the sum of common equity and long-term debt, including current maturities of long-term debt. At June 30, 2006, APS' common equity ratio, as defined, was approximately 54%.

Pinnacle West sponsors a qualified defined benefit and account balance pension plan for the employees of Pinnacle West and our subsidiaries. We contribute at least the minimum amount required under IRS regulations, but no more than the maximum tax-deductible amount. The minimum required funding takes into consideration the value of the plan assets and our pension obligation. The assets in the plan are comprised of common stocks, bonds, common and collective trusts and short-term investments. Future year contribution amounts are dependent on fund performance and valuation assumptions of plan assets. We contributed \$53 million in 2005. The contribution to our pension plan in 2006 is estimated to be approximately \$50 million, \$29 million of which has been contributed through June 30, 2006. The contribution to our other postretirement benefit plan in 2006 is estimated to be approximately \$29 million. APS and other subsidiaries fund their share of the contributions. APS' share is approximately 97% of both plans.

In January 2006, Pinnacle West infused into APS \$210 million of the proceeds from the sale of Silverhawk. See "Equity Infusions" in Note 5 for more information.

On February 28, 2006, Pinnacle West entered into an Uncommitted Master Shelf Agreement with Prudential Investment Management, Inc. ("Prudential") and certain of its affiliates. The agreement provides the terms under which Pinnacle West may offer up to \$200 million of its senior notes for purchase by Prudential affiliates at any time prior to December 31, 2007. The maturity of notes issued under the agreement cannot exceed five years. Pursuant to the agreement, on February 28, 2006, Pinnacle West issued and sold to Prudential affiliates \$175 million of its 5.91% Senior Notes, Series A, due February 28, 2011 (the "Series A Notes").

On April 3, 2006, Pinnacle West repaid \$300 million of its 6.40% Senior Notes due April, 2006. Pinnacle West used the proceeds of the Series A Notes, cash on hand and commercial paper proceeds to repay these notes.



On July 19, 2006, the Pinnacle West Board of Directors declared a quarterly dividend of \$0.50 per share of common stock, payable on September 1, 2006, to shareholders of record on August 1, 2006.

In connection with the FERC Order discussed under "Federal" in Note 5, the FERC revoked a previous FERC order allowing Pinnacle West to issue securities or incur long-term debt without FERC approval. On May 3, 2006, the FERC issued an order approving Pinnacle West's application to issue a broad range of debt and equity securities through June 30, 2008. Pinnacle West does not expect this FERC order to limit its ability to meet its capital requirements.

#### **APS**

APS' capital requirements consist primarily of capital expenditures and optional and mandatory redemptions of long-term debt. APS pays for its capital requirements with cash from operations and, to the extent necessary, external financings. APS has historically paid its dividends to Pinnacle West with cash from operations. See "Pinnacle West (Parent Company)" above for a discussion of the common equity ratio that APS must maintain in order to pay dividends to Pinnacle West.

Although provisions in APS' articles of incorporation and ACC financing orders establish maximum amounts of preferred stock and debt that APS may issue, APS does not expect any of these provisions to limit its ability to meet its capital requirements.

On August 3, 2006, APS issued \$400 million of debt as follows: \$250 million of its 6.25% Notes due 2016 and \$150 million of its 6.875% Notes due 2036. A portion of the proceeds will be used to pay at maturity approximately \$84 million of APS' 6.75% Senior Notes due November 15, 2006, to fund its construction program and for other general corporate purposes. A portion of the proceeds may also be used to pay any liability determined to be payable as a result of the review by the Internal Revenue Service of a tax refund the Company received in 2002.

See "Deferred Fuel and Purchased Power Costs" above and "Power Supply Adjustor" in Note 5 for information regarding the PSA approved by the ACC. Although APS defers actual retail fuel and purchased power costs on a current basis, APS' recovery of the deferrals from its ratepayers is subject to the ACC's approval of annual PSA adjustments and periodic surcharge applications. During the six months ended June 30, 2006, APS recovered approximately \$93 million of PSA deferrals, which had no effect on earnings because of amortization of the same amount recorded as fuel and purchased power expense.

See "Cash Flow Hedges" in Note 10 for information related to collateral provided to us by counterparties.

#### **Pinnacle West Energy**

See Note 17 of Notes to Condensed Consolidated Financial Statements above for a discussion of the sale of our 75% ownership interest in Silverhawk.

### **Other Subsidiaries**

During the past three years, SunCor funded its cash requirements with cash from operations and its own external financings. SunCor's capital needs consist primarily of capital expenditures for land development and retail and office building construction. See the capital expenditures table above for actual capital expenditures during the six months ended June 30, 2006 and projected capital expenditures for the next three years. SunCor expects to fund its future capital requirements with cash from operations and external financings.

El Dorado expects minimal capital requirements over the next three years and intends to focus on prudently realizing the value of its existing investments.

APS Energy Services expects minimal capital expenditures over the next three years.

### **CRITICAL ACCOUNTING POLICIES**

In preparing the financial statements in accordance with GAAP, management must often make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the date of the financial statements and during the reporting period. Some of those judgments can be subjective and complex, and actual results could differ from those estimates. Our most critical accounting policies include the impacts of regulatory accounting, the determination of the appropriate accounting for our pension and other postretirement benefits and derivatives accounting. There have been no changes to our critical accounting policies since our 2005 Form 10-K. See "Critical Accounting Policies" in Item 7 of the 2005 Form 10-K for further details about our critical accounting policies.

### **OTHER ACCOUNTING MATTERS**

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109." This guidance requires us to recognize the tax benefits of an uncertain tax position if it is more likely than not that the benefit will be sustained upon examination by the taxing authority. The Interpretation is effective for fiscal years beginning after December 15, 2006. We are currently evaluating this new guidance and believe it will not have a material impact on our financial statements.

### **PINNACLE WEST CONSOLIDATED - FACTORS AFFECTING OUR FINANCIAL OUTLOOK**

#### **Factors Affecting Operating Revenues, Fuel and Purchased Power Costs**

**General** Electric operating revenues are derived from sales of electricity in regulated retail markets in Arizona and from competitive retail and wholesale power markets in the western United States. These revenues are affected by electricity sales volumes related to customer mix, customer growth and average usage per customer as well as electricity rates and tariffs and variations in weather from period to period. Competitive sales of energy and energy-related products and services are made by APS Energy Services in certain western states that have opened to competition.

**Retail Rate Proceedings** The key issue affecting Pinnacle West's and APS' financial outlook is the satisfactory resolution of APS' retail rate proceedings pending before the ACC. As discussed in greater detail in Note 5, these proceedings consist of a general rate case request; an application for a 1.9% temporary rate increase that is subject to the ACC's completion of an inquiry regarding unplanned 2005 Palo Verde outages; and a "prudence review" of amounts collected through the May 2, 2006 interim PSA adjustor, including a "prudence audit" of unplanned 2006 Palo Verde outages to be conducted by the ACC staff.

**Fuel and Purchased Power Costs** Fuel and purchased power costs are impacted by our electricity sales volumes, existing contracts for purchased power and generation fuel, our power plant performance, transmission availability or constraints, prevailing market prices, new generating plants being placed in service, variances in deferrals and amortization of fuel and purchased power since April 1, 2005 and our hedging program for managing such costs. See "Power Supply Adjustor" in Note 5 for information regarding the PSA, including PSA deferrals related to unplanned Palo Verde outages and reduced power operations that are the subject of ACC prudence reviews. See "Natural Gas Supply" in Note 12 for more information on fuel costs. APS' recovery of PSA deferrals from its ratepayers is subject to the ACC's approval of annual PSA adjustments and periodic surcharge applications.

**Customer and Sales Growth** The customer and sales growth referred to in this paragraph applies to Native Load customers and sales to them. Customer growth in APS' service territory averaged about 3.8% a year for the three years 2003 through 2005; we currently expect customer growth to average about 4.2% per year from 2006 to 2008. We currently estimate that total retail electricity sales in kilowatt-hours will grow 3.7% on average, from 2006 through 2008, before the effects of weather variations. Customer growth was 4.5% higher for the six-month period ended June 30, 2006 when compared with the prior-year period.

Actual sales growth, excluding weather-related variations, may differ from our projections as a result of numerous factors, such as economic conditions, customer growth, usage patterns and responses to retail price changes. Our experience indicates that a reasonable range of variation in our kilowatt-hour sales projection attributable to such economic factors can result in increases or decreases in annual net income of up to \$10 million.

**Weather** In forecasting retail sales growth, we assume normal weather patterns based on historical data. Historical extreme weather variations have resulted in annual variations in net income in excess of \$20 million. However, our experience indicates that the more typical variations from normal weather can result in increases or decreases in annual net income of up to \$10 million.

**Wholesale Power Market Conditions** The marketing and trading division focuses primarily on managing APS' risks relating to fuel and purchased power costs in connection with its costs of serving Native Load customer demand. The marketing and trading division, subject to specified parameters, markets, hedges and trades in electricity, fuels and emission allowances and credits.

#### **Other Factors Affecting Financial Results**

**Operations and Maintenance Expenses** Operations and maintenance expenses are impacted by growth, power plant additions and operations, inflation, outages, higher trending pension and other postretirement benefit costs and other factors.

**Depreciation and Amortization Expenses** Depreciation and amortization expenses are impacted by net additions to utility plant and other property, which include generation construction, acquisition, the sale of generation (see discussion of the sale of Silverhawk – Note 17), changes in depreciation and amortization rates, and changes in regulatory asset amortization.

**Property Taxes** Taxes other than income taxes consist primarily of property taxes, which are affected by tax rates and the value of property in-service and under construction. The average property tax rate for APS, which currently owns the majority of our property, was 9.2% of assessed value for 2005 and 2004. We expect property taxes to increase as new power plants, the acquisition of the Sundance Plant in 2005 and our additions to transmission and distribution facilities are included in the property tax base.

**Interest Expense** Interest expense is affected by the amount of debt outstanding and the interest rates on that debt. The primary factors affecting borrowing levels in the next several years are expected to be our capital requirements and our internally generated cash flow. Capitalized interest offsets a portion of interest expense while capital projects are under construction. We stop accruing capitalized interest on a project when it is placed in commercial operation.

**Retail Competition** Although some very limited retail competition existed in Arizona in 1999 and 2000, there are currently no active retail competitors providing unbundled energy or other utility services to APS' customers. We cannot predict when, and the extent to which, additional competitors will re-enter APS' service territory.

**Subsidiaries** SunCor's net income was \$56 million in 2003, \$45 million in 2004 and \$56 million in 2005.

APS Energy Services' and El Dorado's historical results are not indicative of future performance.

**General** Our financial results may be affected by a number of broad factors. See "Forward-Looking Statements" for further information on such factors, which may cause our actual future results to differ from those we currently seek or anticipate.

## **Market Risks**

Our operations include managing market risks related to changes in interest rates, commodity prices and investments held by our nuclear decommissioning trust fund.

### **Interest Rate and Equity Risk**

We have exposure to changing interest rates. Changing interest rates will affect interest paid on variable-rate debt and the market value of debt securities held by our nuclear decommissioning trust fund. The nuclear decommissioning trust fund also has risk associated with the changing market value of its investments. Nuclear decommissioning costs are recovered in regulated electricity prices.

### **Commodity Price Risk**

We are exposed to the impact of market fluctuations in the commodity price and transportation costs of electricity, natural gas, coal and emissions allowances. We manage risks associated with these market fluctuations by utilizing various commodity instruments that qualify as derivatives, including exchange-traded futures and options and over-the-counter forwards, options and swaps. Our ERM, consisting of officers and key management personnel, oversees company-wide energy risk management activities and monitors the results of marketing and trading activities to ensure compliance with our stated energy risk management and trading policies. As part of our risk management program, we use such instruments to hedge purchases and sales of electricity, fuels and emissions allowances and credits. The changes in market value of such contracts have a high correlation to price changes in the hedged commodities. In addition, subject to specified risk parameters monitored by the ERM, we engage in marketing and trading activities intended to profit from market price movements.

The mark-to-market value of derivative instruments related to our risk management and trading activities are presented in two categories consistent with our business segments:

- Regulated Electricity – non-trading derivative instruments that hedge our purchases and sales of electricity and fuel for APS' Native Load requirements of our regulated electricity business segment; and
- Marketing and Trading – non-trading and trading derivative instruments of our competitive business segment.

The following tables show the pretax changes in mark-to-market of our non-trading and trading derivative positions for the six months ended June 30, 2006 and 2005 (dollars in millions):

	Six Months Ended June 30, 2006		Six Months Ended June 30, 2005	
	Regulated Electricity	Marketing and Trading	Regulated Electricity	Marketing and Trading
Mark-to-market of net positions at beginning of period	\$ 335	\$ 181	\$ 33	\$ 107
Recognized in earnings:				
Change in mark-to-market for future period deliveries – gains (losses)	(6)	(3)	12	12
Mark-to-market gains (losses) realized including ineffectiveness during the period	(4)	1	(1)	(10)
Deferred as a regulatory (asset) liability	(61)	--	4	--
Recognized in OCI:				
Change in mark-to-market for future period deliveries – gains (losses) (a)	(225)	(49)	84	52
Mark-to-market gains realized during the period	(7)	(11)	(6)	(10)
Mark-to-market of net positions at end of period	<u>\$ 32</u>	<u>\$ 119</u>	<u>\$ 126</u>	<u>\$ 151</u>

(a) The gains (losses) in regulated mark-to-market recorded in OCI are due primarily to increases (decreases) in forward natural gas prices.

The tables below show the fair value of maturities of our non-trading and trading derivative contracts (dollars in millions) at June 30, 2006 by maturities and by the source for calculating the fair values. See Note 1, "Derivative Accounting," in Item 8 of our 2005 Form 10-K for more discussion of our valuation methods.

#### Regulated Electricity

Source of Fair Value	2006	2007	2008	2009	2010	Years thereafter	Total fair value
Prices actively quoted	\$ (20)	\$ 63	\$ 20	\$ (1)	\$ --	\$ --	\$ 62
Prices provided by other external sources	(2)	4	(1)	(1)	--	--	--
Prices based on models and other valuation methods	(4)	(4)	(4)	--	(4)	(14)	(30)
Total by maturity	<u>\$ (26)</u>	<u>\$ 63</u>	<u>\$ 15</u>	<u>\$ (2)</u>	<u>\$ (4)</u>	<u>\$ (14)</u>	<u>\$ 32</u>

# **Marketing and Trading**

Source of Fair Value	2006	2007	2008	2009	2010	Years thereafter	Total fair value
Prices actively quoted	\$ 9	\$ --	\$ --	\$ --	\$ --	\$ --	\$ 9
Prices provided by other external sources	--	66	19	--	--	--	85
Prices based on models and other valuation methods	11	(2)	16	(1)	(1)	2	25
Total by maturity	<u>\$ 20</u>	<u>\$ 64</u>	<u>\$ 35</u>	<u>\$ (1)</u>	<u>\$ (1)</u>	<u>\$ 2</u>	<u>\$ 119</u>

The table below shows the impact that hypothetical price movements of 10% would have on the market value of our risk management and trading assets and liabilities included on Pinnacle West's Condensed Consolidated Balance Sheets at June 30, 2006 and December 31, 2005 (dollars in millions).

Commodity	June 30, 2006 Gain (Loss)		December 31, 2005 Gain (Loss)	
	Price Up 10%	Price Down 10%	Price Up 10%	Price Down 10%
Mark-to-market changes reported in earnings (a):				
Electricity	\$ 1	\$ (1)	\$ --	\$ --
Mark-to-market changes reported in OCI (b):				
Electricity	85	(85)	66	(66)
Natural gas	88	(88)	103	(103)
Total	<u>\$ 174</u>	<u>\$ (174)</u>	<u>\$ 169</u>	<u>\$ (169)</u>

- (a) These contracts are primarily structured sales activities hedged with a portfolio of forward purchases that protects the economic value of the sales transactions.
- (b) These contracts are hedges of our forecasted purchases of natural gas and electricity. The impact of these hypothetical price movements would substantially offset the impact that these same price movements would have on the physical exposures being hedged.

## **Credit Risk**

We are exposed to losses in the event of non-performance or non-payment by counterparties. See Note 1, "Derivative Accounting" in Item 8 of our 2005 Form 10-K for a discussion of our credit valuation adjustment policy. See Note 10 for further discussion of credit risk.

## ARIZONA PUBLIC SERVICE COMPANY – RESULTS OF OPERATIONS

### General

Throughout the following explanations of our results of operations, we refer to “gross margin.” Gross margin refers to electric operating revenues less fuel and purchased power costs. Gross margin is a “non-GAAP financial measure,” as defined in accordance with SEC rules. Exhibit 99.2 reconciles this non-GAAP financial measure to operating income, which is the most directly comparable financial measure calculated and presented in accordance with GAAP. We view gross margin as an important performance measure of the core profitability of our operations. This measure is a key component of our internal financial reporting and is used by our management in analyzing our business. We believe that investors benefit from having access to the same financial measures that our management uses. In addition, we have reclassified certain prior-period amounts to conform to our current-period presentation.

### Deferred Fuel and Purchased Power Costs

APS’ retail rate settlement became effective April 1, 2005. As part of the settlement, the ACC approved the PSA, which permits APS to defer for recovery or refund fluctuations in retail fuel and purchased power costs, subject to specified parameters. In accordance with the PSA, APS defers for future rate recovery 90% of the difference between actual retail fuel and purchased power costs and the amount of such costs currently included in base rates. APS’ recovery of PSA deferrals from its customers is subject to the ACC’s approval of annual PSA adjustments and periodic surcharge applications. See “Power Supply Adjustor” in Note 5.

Since the inception of the PSA, APS has incurred substantially higher fuel and purchased power prices than those authorized in APS’ current base rates and has deferred those cost differences in accordance with the PSA. The balance of APS’ PSA deferrals at June 30, 2006 was \$175 million. APS estimates that its PSA deferral balance at December 31, 2006 will be approximately \$155 million to \$175 million, based on APS’ hedged positions for fuel and purchased power at June 30, 2006 and recent forward market prices for natural gas and purchased power (which are subject to change). The recovery of PSA deferrals through ACC approved adjustors and surcharges recorded as revenue is offset dollar-for-dollar by the amortization of those deferred expenses.

APS operated Palo Verde Unit 1 at reduced power levels from December 25, 2005 until March 18, 2006 due to vibration levels in one of the Unit’s shutdown cooling lines. During an outage at Unit 1 from March 18, 2006 to July 7, 2006, APS performed the necessary work and modifications to remedy the situation. APS estimates that incremental replacement power costs resulting from Palo Verde’s outages and reduced power levels were approximately \$78 million during the six months ended June 30, 2006. The related PSA deferrals were approximately \$70 million in that period. The Palo Verde replacement power costs were partially offset by \$30 million of lower than expected replacement power costs related to APS’ fossil-fueled generating units during the six months ended June 30, 2006. As a result, the corresponding deferrals were reduced in that six-month period by \$27 million.

The PSA deferral balance at June 30, 2006 and estimated balance as of December 31, 2006 each includes (a) \$45 million related to replacement power costs associated with unplanned 2005 Palo Verde outages and (b) \$70 million related to replacement power costs associated with unplanned 2006 outages or reduced power operations at Palo Verde. The PSA deferrals associated



with these unplanned Palo Verde outages and reduced power operations are the subject of ACC prudence reviews. See "PSA Deferrals Related to Unplanned Palo Verde Outages" in Note 5.

See "Power Supply Adjustor" in Note 5 for further information regarding the PSA.

**Operating Results – Three-month period ended June 30, 2006 compared with three-month period ended June 30, 2005**

APS' net income for the three months ended June 30, 2006 was \$94 million compared with \$64 million for the comparable prior-year period. The \$30 million increase was primarily due to the higher retail sales volumes due to customer growth; effects of warmer weather on retail sales; and income tax credits related to prior years resolved in 2006. These positive factors were partially offset by higher operations and maintenance expense related to generation and customer service costs and higher depreciation and amortization related to increased depreciable assets. In addition, the increase also related to the absence of a prior year cost-based contract for PWEC Dedicated Assets which was partially offset by increased operations and maintenance expense and depreciation of those units. Higher fuel and purchased power costs (as discussed above) were substantially offset by the deferral of those costs in accordance with the PSA.

Additional details on the major factors that increased (decreased) net income are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Gross margin:		
Higher fuel and purchased power costs	\$ (43)	\$ (26)
Deferred fuel and purchased power costs	40	24
Absence of prior year cost-based contract for PWEC Dedicated Assets	40	24
Higher retail sales volumes due to customer growth, excluding weather effects	26	16
Effects of warmer weather on retail sales	16	10
Miscellaneous items, net	(11)	(6)
Net increase in gross margin	68	42
Operations and maintenance increases primarily due to:		
Costs of PWEC Dedicated Assets not included in prior year period	(8)	(5)
Generation costs, including maintenance and overhauls	(6)	(4)
Customer service costs, including regulatory demand-side management programs and planned maintenance	(6)	(4)
Miscellaneous items, net	(6)	(4)
Depreciation and amortization increases primarily due to:		
Higher depreciable assets due to transfer of PWEC Dedicated Assets	(6)	(4)
Higher other depreciable assets partially offset by lower depreciation rates	(5)	(3)
Income tax credits related to prior years resolved in 2006	--	7
Miscellaneous items, net	1	5
Net increase in net income	<u>\$ 32</u>	<u>\$ 30</u>

### **Regulated Electricity Revenues**

Regulated electricity revenues were \$133 million higher for the three months ended June 30, 2006 compared with the prior-year period primarily as a result of:

- a \$75 million increase in revenues related to recovery of PSA deferrals, which had no earnings effect because of amortization of the same amount recorded as fuel and purchased power expense (see "Deferred Fuel and Purchased Power Costs" above);
- a \$36 million increase in retail revenues related to customer growth, excluding weather effects;
- a \$22 million increase in retail revenues related to warmer weather;
- a \$10 million increase in Off-System Sales due to higher prices; and
- a \$10 million decrease due to miscellaneous factors.

### **Operating Results – Six-month period ended June 30, 2006 compared with six-month period ended June 30, 2005**

APS' net income for the six months ended June 30, 2006 was \$88 million compared with \$91 million for the comparable prior-year period. The \$3 million decrease was primarily due to higher fuel and purchased power costs (as discussed above); higher operations and maintenance expense related to generation and customer service costs; and higher depreciation and amortization related to increased depreciable assets. These negative factors were partially offset by deferred fuel and purchased power costs; higher retail sales volumes due to customer growth; effects of weather on retail sales; income tax credits related to prior years resolved in 2006; and a retail price increase effective April 1, 2005. In addition, the increase also related to the absence of a prior year cost-based contract for PWEC Dedicated Assets which was partially offset by increased operations and maintenance expense and depreciation of those units.

Additional details on the major factors that increased (decreased) net income are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Gross margin:		
Higher fuel and purchased power costs	\$ (98)	\$ (60)
Deferred fuel and purchased power costs (deferrals began April 1, 2005)	53	32
Absence of prior year cost-based contract for PWEC Dedicated Assets	42	26
Higher retail sales volumes due to customer growth, excluding weather effects	39	24
Effects of weather on retail sales	13	8
Higher marketing and trading gross margin primarily related to higher mark-to-market gains	13	8
Retail price increase effective April 1, 2005	7	4
Miscellaneous items, net	(15)	(9)
Net increase in gross margin	54	33
Operations and maintenance increases primarily due to:		
Generation costs, including maintenance and overhauls	(25)	(15)
Costs of PWEC Dedicated Assets not included in prior year period	(15)	(9)
Customer service costs, including regulatory demand-side management programs and planned maintenance	(12)	(7)
Miscellaneous items, net	(5)	(3)
Depreciation and amortization increases primarily due to:		
Higher depreciable assets due to transfer of PWEC Dedicated Assets	(12)	(7)
Higher other depreciable assets partially offset by lower depreciation rates	(3)	(2)
Higher property taxes due to increased plant in service	(5)	(3)
Income tax credits related to prior years resolved in 2006	--	7
Miscellaneous items, net	2	3
Net decrease in net income	\$ (21)	\$ (3)

### Regulated Electricity Revenues

Regulated electricity revenues were \$182 million higher for the six months ended June 30, 2006 compared with the prior-year period primarily as a result of:

- a \$93 million increase in revenues related to recovery of PSA deferrals, which had no earnings effect because of amortization of the same amount recorded as fuel and purchased power expense (see "Deferred Fuel and Purchased Power Costs" above);
- a \$54 million increase in retail revenues related to customer growth, excluding weather effects;

- an \$18 million increase in retail revenues related to weather;
- a \$12 million increase in Off-System Sales primarily resulting from sales previously reported in marketing and trading that were classified beginning in April 2005 as sales in regulated electricity in accordance with the APS retail rate case settlement;
- a \$10 million increase in Off-System Sales due to higher prices;
- a \$7 million increase in retail revenues due to a price increase effective April 1, 2005; and
- a \$12 million decrease due to miscellaneous factors.

### **Marketing and Trading Revenues**

Marketing and trading revenues were \$16 million lower for the six months ended June 30, 2006 compared with the prior-year period primarily as a result of:

- a \$15 million decrease in energy trading revenues on realized sales of electricity primarily due to lower delivered electricity prices and lower volumes;
- an \$11 million increase in mark-to-market gains on contracts for future delivery due to changes in forward prices; and
- a \$12 million decrease in Off-System Sales due to the absence of sales previously reported in marketing and trading that were classified beginning in April 2005 as sales in regulated electricity in accordance with the APS retail rate case settlement.

## **ARIZONA PUBLIC SERVICE COMPANY – LIQUIDITY AND CAPITAL RESOURCES**

### **Contractual Obligations**

APS' future contractual obligations have not changed materially from the amounts disclosed in Part II, Item 7 of the 2005 Form 10-K, with the exception of our aggregate:

- fuel and purchased power commitments, which increased from approximately \$1.7 billion at December 31, 2005 to \$2.7 billion at June 30, 2006 as follows (in billions):

2006	2007-2008	2009-2010	Thereafter	Total
\$0.4	\$0.5	\$0.4	\$1.4	\$2.7

See Note 4 for a list of APS' payments due on total long-term debt and capitalized lease requirements.

## FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements based on current expectations, and neither Pinnacle West nor APS assumes any obligation to update these statements or make any further statements on any of these issues, except as required by applicable law. These forward-looking statements are often identified by words such as "estimate," "predict," "hope," "may," "believe," "anticipate," "plan," "expect," "require," "intend," "assume" and similar words. Because actual results may differ materially from expectations, we caution readers not to place undue reliance on these statements. A number of factors could cause future results to differ materially from historical results, or from results or outcomes currently expected or sought by Pinnacle West or APS. In addition to the Risk Factors described in Item 1A of the 2005 Form 10-K, these factors include, but are not limited to:

- state and federal regulatory and legislative decisions and actions, including the outcome and timing of APS' retail rate proceedings pending before the ACC;
- the timely recovery of PSA deferrals, including approximately \$115 million of deferrals at June 30, 2006 associated with unplanned Palo Verde outages and reduced power operations that are the subject of ACC prudence reviews;
- the ongoing restructuring of the electric industry, including the introduction of retail electric competition in Arizona and decisions impacting wholesale competition;
- the outcome of regulatory, legislative and judicial proceedings, both current and future, relating to the restructuring;
- market prices for electricity and natural gas;
- power plant performance and outages;
- transmission outages and constraints;
- weather variations affecting local and regional customer energy usage;
- customer growth and energy usage;
- regional economic and market conditions, including the results of litigation and other proceedings resulting from the California energy situation, volatile fuel and purchased power costs and the completion of generation and transmission construction in the region, which could affect customer growth and the cost of power supplies;
- the cost of debt and equity capital and access to capital markets;
- current credit ratings remaining in effect for any given period of time;
- our ability to compete successfully outside traditional regulated markets (including the wholesale market);
- the performance of our marketing and trading activities due to volatile market liquidity and any deteriorating counterparty credit and the use of derivative contracts in our business (including the interpretation of the subjective and complex accounting rules related to these contracts);
- changes in accounting principles generally accepted in the United States of America and the interpretation of those principles;
- the performance of the stock market and the changing interest rate environment, which affect the amount of required contributions to Pinnacle West's pension plan and APS' nuclear decommissioning trust funds, as well as the reported costs of providing pension and other postretirement benefits;
- technological developments in the electric industry;

- the strength of the real estate market in SunCor's market areas, which include Arizona, Idaho, New Mexico and Utah; and
- other uncertainties, all of which are difficult to predict and many of which are beyond the control of Pinnacle West and APS.

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

See "Pinnacle West Consolidated – Factors Affecting Our Financial Outlook - Market Risks" in Item 2 above for a discussion of quantitative and qualitative disclosures about market risks.

**Item 4. CONTROLS AND PROCEDURES**

**(a) Disclosure Controls and Procedures**

The term "disclosure controls and procedures" means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Securities Exchange Act of 1934 (the "Exchange Act") (15 U.S.C. 78a *et seq.*) is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to a company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Pinnacle West's management, with the participation of Pinnacle West's Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of Pinnacle West's disclosure controls and procedures as of June 30, 2006. Based on that evaluation, Pinnacle West's Chief Executive Officer and Chief Financial Officer have concluded that, as of that date, Pinnacle West's disclosure controls and procedures were effective.

APS' management, with the participation of APS' Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of APS' disclosure controls and procedures as of June 30, 2006. Based on that evaluation, APS' Chief Executive Officer and Chief Financial Officer have concluded that, as of that date, APS' disclosure controls and procedures were effective.

**(b) Changes In Internal Control Over Financial Reporting**

The term "internal control over financial reporting" (defined in SEC Rule 13a-15(f)) refers to the process of a company that is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

No change in Pinnacle West's or APS' internal control over financial reporting occurred during the fiscal quarter ended June 30, 2006 that materially affected, or is reasonably likely to materially affect, Pinnacle West's or APS' internal control over financial reporting.

## Part II - OTHER INFORMATION

### Item 1. LEGAL PROCEEDINGS

See Note 12 of Notes to Condensed Consolidated Financial Statements in Part I, Item 1 of this report in regard to pending or threatened litigation or other disputes.

### Item 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in the 2005 Form 10-K, which could materially affect the business, financial condition or future results of APS and Pinnacle West. The risks described in this report and the 2005 Form 10-K are not the only risks facing APS and Pinnacle West. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect the business, financial condition and/or operating results of APS and Pinnacle West.

### Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

#### Proposal 1 - Election of Directors

At our Annual Meeting of Shareholders held on May 17, 2006, the following persons were elected as directors:

Class III (Term to expire at 2009 Annual Meeting)	Votes For	Votes Withheld	Abstentions and Broker Non-Votes
Jack E. Davis	86,958,623	1,821,065	N/A
Pamela Grant	86,967,924	1,811,764	N/A
Martha O. Hesse	86,924,165	1,855,523	N/A
William S. Jamieson, Jr.	86,990,842	1,788,846	N/A

#### Continuing Directors

The terms of Roy A. Herberger, Jr., Humberto S. Lopez, Kathryn L. Munro, and William L. Stewart will expire in 2007. The terms of Edward N. Basha, Jr., Michael L. Gallagher, Bruce J. Nordstrom and William J. Post will expire in 2008.

#### Proposal 2 - Independent Auditors

At the same meeting, a proposal for the ratification of the selection of Deloitte & Touche LLP as independent Auditors of the Company for fiscal year ending 2006 was submitted to the shareholders, and the voting was as follows:



Proposal for the ratification of the selection of Deloitte & Touche LLP for fiscal year ending 2006	Votes For	Votes Against	Abstentions and Broker Non-Votes
	87,880,830	234,347	664,511

### **Proposal 3 – Shareholder Proposal**

Also at this annual meeting, a shareholder proposal requesting that the Board of Directors take action to allow for the annual election of directors was submitted to the shareholders, and the voting was as follows:

Proposal to elect each director annually	Votes For	Votes Against	Abstentions and Broker Non-Votes
	61,797,460	12,834,465	14,147,763

## **Item 5. OTHER INFORMATION**

### **Construction and Financing Programs**

See “Liquidity and Capital Resources” in Part I, Item 2 of this report for a discussion of construction and financing programs of the Company and its subsidiaries.

### **Regulatory Matters**

See Note 5 of Notes to Condensed Consolidated Financial Statements in Part I, Item 1 of this report for a discussion of regulatory developments.

### **Environmental Matters**

See “Environmental Matters – Superfund” in Note 12 of Notes to Condensed Consolidated Financial Statements in Part I, Item 1 of this report for a discussion of a Superfund site.

**Mercury.** By November 2006, the Arizona Department of Environmental Quality will submit a State Implementation Plan to the EPA to implement the Clean Air Mercury Rule or an alternate mercury program, as authorized by the EPA. See “Environmental Matters – Mercury” in Part I, Item 1 of the 2005 Form 10-K. ADEQ issued a proposed mercury rule on July 25, 2006. The proposed rule generally incorporates EPA’s model cap-and-trade program, but requires sources to acquire two allowances for every one allowance needed for compliance. The proposed rule also requires coal-fired power plants to achieve a 90% mercury removal efficiency or to achieve certain emission limits. APS is still evaluating the potential impacts of the proposed rule and cannot currently estimate the expenditures which may be required.

**Federal Implementation Plan.** In September 1999, the EPA proposed a FIP to set air quality standards at certain power plants, including the Navajo Generating Station and the Four Corners Power Plant. See "Environmental Matters – Federal Implementation Plan" in Part I, Item 1 of the 2005 Form 10-K. On July 26, 2006, the Sierra Club sued the EPA to compel the EPA to issue a final FIP for Four Corners Power Plant. APS does not currently expect the FIP to have a material adverse effect on its financial position, results of operations, cash flows or liquidity.

**Item 6. EXHIBITS**

(a) Exhibits

<u>Exhibit No.</u>	<u>Registrant(s)</u>	<u>Description</u>
10.1	Pinnacle West	First Amendment to Amended and Restated Credit Agreement, dated as of May 15, 2006, supplementing and amending the Amended and Restated Credit Agreement, dated as of December 9, 2005, among Pinnacle West Capital Corporation, as Borrower, JPMorgan Chase Bank, N.A., as Agent and the other parties thereto
12.1	Pinnacle West	Ratio of Earnings to Fixed Charges
12.2	APS	Ratio of Earnings to Fixed Charges
12.3	Pinnacle West	Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividend Requirements
31.1	Pinnacle West	Certificate of William J. Post, Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.2	Pinnacle West	Certificate of Donald E. Brandt, Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.3	APS	Certificate of Jack E. Davis, Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.4	APS	Certificate of Donald E. Brandt, Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
32.1	Pinnacle West	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to 18 U.S.C. Section 1850, as adopted pursuant to Section 906 of the Sarbanes-

<i><b>Exhibit No.</b></i>	<i><b>Registrant(s)</b></i>	<i><b>Description</b></i>
		Oxley Act of 2002
32.2	APS	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to 18 U.S.C. Section 1850, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.1	Pinnacle West	Reconciliation of Operating Income to Gross Margin
99.2	APS	Reconciliation of Operating Income to Gross Margin

In addition, the Company hereby incorporates the following Exhibits pursuant to Exchange Act Rule 12b-32 and Regulation §229.10(d) by reference to the filings set forth below:

<i><b>Exhibit No.</b></i>	<i><b>Registrant(s)</b></i>	<i><b>Description</b></i>	<i><b>Previously Filed as Exhibit<sup>a</sup></b></i>	<i><b>Date Effective</b></i>
3.1	Pinnacle West	Articles of Incorporation, restated as of July 29, 1988	19.1 to Pinnacle West's September 1988 Form 10-Q Report, File No. 1-8962	11-14-88
3.2	Pinnacle West	Pinnacle West Capital Corporation Bylaws, amended as of December 14, 2005	3.1 to Pinnacle West/APS December 9, 2005 Form 8-K Report, File Nos. 1-8962 and 1-4473	12-15-05
3.3	APS	Articles of Incorporation, restated as of May 25, 1988	4.2 to APS' Form S-3 Registration Nos. 33-33910 and 33-55248 by means of September 24, 1993 Form 8-K Report, File No. 1-4473	9-29-93
3.4	APS	Arizona Public Service Company Bylaws, amended as of June 23, 2004	3.1 to APS' June 30, 2004 Form 10-Q Report, File No. 1-4473	8-9-04

<sup>a</sup> Reports filed under File Nos. 1-4473 and 1-8962 were filed in the office of the Securities and Exchange Commission located in Washington, D.C.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, each registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

### PINNACLE WEST CAPITAL CORPORATION (Registrant)

Dated: August 8, 2006

By: /s/ Donald E. Brandt  
Donald E. Brandt  
Executive Vice President and Chief  
Financial Officer  
(Principal Financial Officer  
and Officer Duly Authorized to sign this Report)

### ARIZONA PUBLIC SERVICE COMPANY (Registrant)

Dated: August 8, 2006

By: /s/ Donald E. Brandt  
Donald E. Brandt  
Executive Vice President and Chief  
Financial Officer  
(Principal Financial Officer and  
Officer Duly Authorized to sign this Report)

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EXHIBIT D  
Certain Language for Proposed Order

EXHIBIT D

PROPOSED LANGUAGE FOR ORDER

[Capitalized terms used in the paragraphs below are intended to have the meanings given in the Application.]

IT IS THEREFORE ORDERED that the Company is hereby authorized (i) to issue, sell, and incur the Continuing Long-Term Debt and the Continuing Short-Term Debt, redeem, refinance, refund, renew, reissue, roll-over, repay, and re-borrow from time to time such Continuing Long-Term Debt and Continuing Short-Term Debt, and establish and amend the terms and provisions of long-term and short-term indebtedness from time to time, (ii) to determine the form of security, if any, for the Continuing Long-Term Debt and the Continuing Short-Term Debt, execute and deliver the Security Instruments, and establish and amend the terms and provisions of the Security Instruments, as may be deemed appropriate by the Company in connection with the Continuing Long-Term Debt and the Continuing Short-Term Debt, and (iii) to pay all related expenses, all as contemplated in the Application and by the exhibits and testimony presented during the hearing in this matter.

IT IS FURTHER ORDERED that only traditional indebtedness for borrowed money (and not the other types of arrangements described in paragraph 13 of the Application) is subject to A.R.S. Sections 301 and 302 and that, therefore, such other arrangements will not count against the Continuing Long-Term Debt or Continuing Short-Term Debt authorizations provided in this Decision or require prior Commission approval.

IT IS FURTHER ORDERED that the Company is hereby authorized to sign and deliver such documents and to engage in such acts as are reasonably necessary to effectuate the authorization granted hereinabove.

IT IS FURTHER ORDERED that the purposes for which the proposed issuances of Continuing Long-Term Debt and the Continuing Short-Term Debt are herein authorized are to augment the funds available from all sources to finance the Company's construction, resource acquisition and maintenance programs, to redeem or retire outstanding securities, to repay or refund other outstanding long-term or short-term debt and to meet certain of the Company's working capital and other cash requirements. Such purposes are within those permitted by A.R.S. Section 301 and are permitted regardless of the extent to which they may be reasonably chargeable to operating expenses or to income.

IT IS FURTHER ORDERED that Pinnacle West is hereby granted an ongoing waiver of and authorization under A.C.C. R14-2-803 for the purpose of guaranteeing the Company's indebtedness from time to time. The Company is hereby authorized to reimburse Pinnacle West for any amounts paid by Pinnacle West under any guarantee of the Company's debt from time to time, along with interest thereon to the date of reimbursement at a rate of interest not greater than the rate payable on the debt so guaranteed and paid by Pinnacle West.

IT IS FURTHER ORDERED That this Decision shall become effective immediately.



## Exhibit 2

# APS Comments on Staff Report

**ORIGINAL**

**BEFORE THE ARIZONA CORPORATION  
RECEIVED**

28

COMMISSIONERS

2007 MAY 29 P 2:33

MIKE GLEASON, Chairman  
WILLIAM A. MUNDELL  
JEFF HATCH-MILLER  
KRISTIN K. MAYES  
GARY PIERCE

AZ CORP COMMISSION  
DOCKET CONTROL

IN THE MATTER OF THE APPLICATION  
OF ARIZONA PUBLIC SERVICE  
COMPANY FOR AN ORDER OR  
ORDERS AUTHORIZING IT TO ISSUE,  
INCUR, AND AMEND EVIDENCES OF  
LONG-TERM INDEBTEDNESS AND  
SHORT-TERM INDEBTEDNESS, TO  
EXECUTE NEW SECURITY  
INSTRUMENTS, TO SECURE ANY  
SUCH INDEBTEDNESS, TO REPAY  
AMOUNTS PAID UNDER ANY  
PINNACLE WEST CAPITAL  
CORPORATION GUARANTEE OF  
ARIZONA PUBLIC SERVICE COMPANY  
INDEBTEDNESS AND FOR  
DECLARATORY ORDER

DOCKET NO. E-01345A-06-0779

IN THE MATTER OF THE APPLICATION  
OF PINNACLE WEST CAPITAL  
CORPORATION FOR AN ORDER OR  
ORDERS AUTHORIZING IT TO  
GUARANTEE THE INDEBTEDNESS OF  
ARIZONA PUBLIC SERVICE COMPANY

Arizona Corporation Commission  
**DOCKETED**

MAY 29 2007

DOCKETED BY

nr

**COMMENTS OF ARIZONA PUBLIC SERVICE COMPANY**

**ON STAFF REPORT**

**I. INTRODUCTION**

Arizona Public Service Company ("APS" or the "Company") hereby submits the following comments on the Staff Report (the "Staff Report") filed in the above docket on May 18, 2007. The Staff Report recognizes the continued benefits to APS and its customers of the financial flexibility that previous Arizona Corporation Commission

1 ("Commission") financing orders have provided since 1984. The Company supports the  
2 Staff Report's fundamental recommendations but must suggest specific modifications and  
3 clarifications, as discussed in greater detail below. In doing so, the Company seeks to  
4 insure that the flexibility and other benefits provided by a new financing order are not lost  
5 because APS or APS' future lenders and investors are unable to definitively confirm that  
6 the Commission has clearly authorized a particular debt issuance or how any limitation on  
7 that authority is to be interpreted.  
8

9  
10 Pinnacle West Capital Corporation ("Pinnacle West") joins in this filing for the  
11 purpose of the subject matter of Paragraph 14 below. Paragraph 14 addresses Pinnacle  
12 West's request to guarantee the debt of APS, which likely constitutes a "reorganization"  
13 of Pinnacle West under A.A.C. R14-2-803.  
14

15 Capitalized terms used in this filing that are not otherwise specifically  
16 defined in these comments have the meanings ascribed to those terms in the APS/Pinnacle  
17 West Verified Application in this Docket, dated December 15, 2006 (the "Application").  
18

## 19 II. CONDITIONS TO ISSUANCES OF DEBT

20 1. The Staff Report recommends Commission approval of the Company's requested  
21 increase in its Continuing Long-Term Debt limit to \$4.2 billion if, "subsequent to any debt  
22 issuance, APS can satisfy the following conditions: (1) common equity must represent at  
23 least 40 percent of total [capital] (common equity, preferred stock, long-term debt and  
24 short-term debt) and (2) the debt service coverage ratio ("DSC") is equal to or greater than  
25 1.0." (Staff Report at 5.)  
26  
27  
28

1 2. As explained in greater detail below, the Company agrees with the Staff's  
2 recommendation regarding a common equity and debt service coverage test, subject to  
3 specific clarifications and modifications. As a preliminary matter, however, the Company  
4 requests that instead of the tests applying to "any debt issuance," the tests should apply  
5 only when the Company is issuing long-term debt in recognition of the fact that the  
6 Company normally issues short-term debt in the form of commercial paper on a daily  
7 basis. Computing these tests on a daily basis would be impractical and unnecessarily  
8 burdensome. The Company agrees that a short-term debt component would be included  
9 in the coverage calculations at the time the Company issues long-term debt.  
10  
11

#### 12 Calculation of Common Equity Test

13 3. Commission Decision No. 65796 (April 4, 2003), which prohibits APS from  
14 paying dividends unless it maintains a minimum common equity ratio of 40%, calculates  
15 the common equity percentage as follows: "APS' common equity [shall] be divided by  
16 the sum of such common equity and APS long-term debt (including current maturities of  
17 such debt)." (Commission Decision No. 65796 at 25.) Although there is little difference  
18 between the two calculations under normal circumstances, for the sake of consistency of  
19 application, the calculation methodology in Commission Decision No. 65796 should be  
20 adopted for purposes of this limitation. APS also proposes that the calculation be made as  
21 of the end of APS' most recent fiscal quarter, adjusted to give effect to the issuance of any  
22 new indebtedness. Calculations of APS' common equity percentages under each  
23 approach at March 31, 2007, APS' most recent fiscal quarter, are attached to this filing as  
24 Exhibit A.  
25  
26  
27  
28

**Debt Service Coverage Ratio**

4. The Staff Report recommends that the DSC be “calculated as operating income plus depreciation and amortization and income tax divided by interest and [principal] on short-term and long-term debt less short-term debt and interest related to purchased power and natural gas and using the most recent audited financial statements adjusted to reflect changes to outstanding debt.” (Staff Report at 5, n. 1.)

5. APS acknowledges the Staff’s request “for financial parameters to place conditions on the borrowings to prevent APS from taking on an excessive amount of debt” (Staff Report at 4). APS believes that the common equity ratio referenced in Paragraph 2, combined with a debt service coverage test, could effectively address this request. As proposed by the Staff, however, the DSC would require numerous modifications and clarifications so that the DSC calculation methodology is clear under the various circumstances when the DSC would need to be calculated. Absent these modifications and clarifications, neither APS nor APS’ future lenders and investors will have the required certainty that the Commission has clearly authorized APS’ incurrence of a specific debt obligation. As a result, APS proposes a “Modified DSC,” as discussed below.

(a) The inclusion of long-term and short-term principal debt repayments in the “denominator” of the DSC calculation would result in (i) a debt service coverage calculation inconsistent with APS’ historical financing program and the coverage tests applied to APS by its lenders and the rating agencies and (ii) numerous interpretive issues, which are addressed below in clause (c) of this Paragraph 5.

1 (b) Historically, APS' debt has not been amortized and repaid over the life of  
2 the debt, as is the case with the debt of many other public service corporations regulated  
3 by the Commission. With amortizing debt, much like a typical home mortgage loan, a  
4 portion of each payment is used to pay down principal. On the other hand, APS and other  
5 large investor-owned utilities generally repay in full their outstanding debt obligations at  
6 maturity, usually with the proceeds of another debt issuance. During 2005, for example,  
7 APS repaid approximately \$568 million of maturing long-term debt and issued  
8 approximately \$412 million of new long-term debt. When APS repays its long-term debt,  
9 the DSC will be artificially reduced and will not provide an accurate measure of APS'  
10 financial health given that APS generally issues new debt to replace the "bullet maturity"  
11 debt. Similarly, maturing short-term debt is typically rolled over with new issuances of  
12 short-term debt. APS proposes a modified DSC (the "Modified DSC") that would exclude  
13 principal debt repayments. The coverage test that would be reflected in the Modified DSC  
14 is widely accepted in the financial community and is the only type of coverage test found  
15 in APS' credit agreements. In addition, the rating agencies evaluate APS using this type  
16 of coverage test. Calculations of the DSC (using the Company's best interpretation of that  
17 test) and the proposed Modified DSC at December 31, 2006 are attached to this filing as  
18 Exhibit B.<sup>1</sup>

23 (c) If the Commission determines that the DSC, rather than the Modified DSC,  
24 is an appropriate financial test, APS requests that the Commission address the issues  
25  
26

27 <sup>1</sup> Under the DSC, the Staff also recommended the exclusion of "short-term debt and interest related to purchased  
28 power and natural gas" from the denominator of the DSC calculation. Under the Modified DSC, APS proposes that  
this exclusion would no longer be necessary.

1 related to the DSC that are set forth on Exhibit C, which APS believes are the significant,  
2 but perhaps not the only, issues that must be addressed to resolve existing ambiguities.  
3

### 4 **III. OTHER STAFF REPORT RECOMMENDATIONS**

#### 5 **Short-Term Debt Limit**

6 6. The Staff Report recommends that the Commission authorize APS to incur short-  
7 term debt of up to 7% of APS' capitalization plus up to \$500 million of additional short-  
8 term borrowings for purchases of natural gas and power. (Staff Report at 5.) APS agrees  
9 with this recommendation but requests two modifications:  
10

11 (a) First, the Staff Report recommends that, as a condition of APS incurring the  
12 additional \$500 million of short-term debt, "APS has a Commission authorized adjustor  
13 mechanism for recovery of these costs" (Staff Report at 6). For purposes of clarity, APS  
14 suggests that the phrase "for recovery of these costs" be changed to "for recovery of  
15 natural gas or power purchases."  
16

17 (b) Second, if the "Commission authorized mechanism" is terminated, APS  
18 requests that the Commission's authorization for the related short-term debt would  
19 terminate 12 months thereafter. This would provide APS with sufficient time to prudently  
20 address its short-term debt balances.  
21

#### 22 **Declaratory Order Regarding Traditional Indebtedness for Borrowed Money**

23 7. The Staff Report recommends that the Commission deny APS' request for a  
24 declaratory order confirming that only traditional indebtedness for borrowed money  
25 requires prior Commission authorization. (Staff Report at 5.) If the Commission accepts  
26 the Staff's recommendation in this regard, APS suggests that the Commission adopt the  
27  
28

1 following additional provisions to avoid unintended and patently unfair consequences  
2 should APS exceed its authorized debt limits solely as a result of future changes in United  
3 States generally accepted accounting principles ("GAAP") or future changes in the  
4 interpretation of GAAP (collectively, "GAAP Changes"):  
5

6 (a) Any contract or other legally-binding arrangement to which APS was a  
7 party as of the date of the Commission's order in this matter (the "Existing Obligations"),  
8 will not be considered indebtedness for purposes of the order (including the order's debt  
9 limitations, common equity test, and debt service coverage test) if the Existing Obligation  
10 was not considered indebtedness under GAAP as of such date.  
11

12 (b) If a GAAP Change subsequently occurs that results in an Existing  
13 Obligation being reclassified as indebtedness, APS will notify the Commission of such  
14 GAAP Change within 30 days after APS files its Quarterly Report on Form 10-Q or its  
15 Annual Report on Form 10-K with the Securities and Exchange Commission following  
16 the end of the fiscal quarter in which such GAAP Change occurs (the "Notification  
17 Period").  
18

19 (c) If, after the Commission's issuance of an order in this matter, APS enters  
20 into a contract or binding arrangement that is not considered indebtedness under GAAP  
21 but subsequently is considered indebtedness because of a GAAP Change, APS'  
22 obligations under such contract or arrangement will not be considered indebtedness for  
23 purposes of the order (including the order's debt limitations, common equity test, and debt  
24 service coverage test) until further Commission action if, within the Notification Period,  
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1 APS files an application with the Commission specifically requesting approval of such  
2 reclassified debt obligations.

3  
4 **Replacement of Existing Authorizations**

5 8. The Staff Report recommends that "[the] authorizations to incur short-term and  
6 long-term debt obligations provided in this proceeding should replace all existing  
7 authorizations, and all existing authorizations should terminate upon the effective date of  
8 the authorizations provided in this proceeding." (Staff Report at 6.)

9  
10 9. APS agrees with Staff's recommendations in this regard, which APS believes were  
11 focused on Decision Nos. 55017 (May 6, 1986) and 54230 (November 8, 1984) (identified  
12 in the Application as the 1986 Order and the 1984 Order, respectively), with the following  
13 exceptions. Commission Decision Nos. 55120 (July 24, 1986) and 55320 (December 5,  
14 1986) (the "Sale-Leaseback Authorizations") are separate and independent financing  
15 authorizations that must remain in full force and effect. Each of these Decisions, copies  
16 of which are attached as Exhibits D and E, respectively, relates to the Company's sale and  
17 leaseback of a portion of Unit 2 of the Palo Verde Nuclear Generating Station. The Sale-  
18 Leaseback Authorizations, pursuant to which APS entered into three separate sale-  
19 leaseback transactions in 1986, are also financing authorizations in that they permit APS  
20 to:  
21  
22

23 "issue, assume, guarantee, and incur evidences of indebtedness in order to  
24 consummate, and to perform its obligations and exercise its options under,  
25 the Lease Transactions (including the issuance or incurrence of evidences of  
26 indebtedness in connection with the financing of Capital Improvements as  
27 required or permitted by the terms of the Leases, the costs of which will be  
28 reflected in an adjustment to lease rentals) including, but not limited to, (i)  
the issuance or incurrence of evidences of indebtedness by the Funding  
Corporation, secured by the direct obligation of the Company; (ii) the

1 issuance or incurrence of evidences of indebtedness in connection with any  
2 letter of credit or financial guaranty securing the Equity Investors for the  
3 payment of amounts payable by the Company under the Lease and related  
4 documents; (iii) the issuance or incurrence of evidences of indebtedness  
5 necessary for any refunding of indebtedness; (iv) the assumption of  
6 indebtedness by the Company upon the occurrence of certain events as  
7 required by the Leases; (v) the adjustment of rents from time to time as  
8 required by the Leases; and (vi) the extension of supplements to the Lease  
9 as required or permitted by the Leases." (Decision No. 55120 at 9-10.)

10 10. It is important to APS and the numerous other parties to the sale-leaseback  
11 transactions that the Sale-Leaseback Authorizations remain in full force and effect. The  
12 parties entered into those transactions in reliance upon the Sale-Leaseback Authorizations.

#### 13 Termination of Authorizations Under New Order

14 11. The Staff Report recommends that "[the] short-term and long-term debt levels  
15 authorized in this proceeding terminate on December 31, 2012." (Staff Report at 6.) In  
16 order to alleviate potential concerns about the validity of APS' indebtedness after  
17 December 31, 2012, APS suggests that the Commission order in this proceeding confirm  
18 that all short-term and long-term debt legally outstanding at December 31, 2012 remain  
19 authorized and valid obligations of APS.

20 12. APS also requests that the December 31, 2012 termination date be extended until  
21 the Commission issues a new financing order replacing the then-existing order, provided  
22 that (a) APS files an application for a new financing order on or before December 31,  
23 2011 and (b) the Commission has not issued an order pursuant to such application on or  
24 before December 31, 2012. This will ensure that APS' ability to access the capital  
25 markets is not abruptly terminated, which would prohibit APS from funding its ongoing  
26 operations and meeting its obligations as a public service corporation.  
27  
28

Miscellaneous Comments

13. The Staff Report states that "[t]o the extent that the purposes set forth in the application may be considered reasonably chargeable to operating expenses or to income, APS requests that the order or orders from the Commission in this matter authorize such charge or charges and that they be deemed working capital requirements." (Staff Report at 3.) The Application did not request the Commission to find that purposes reasonably chargeable to operating expenses or to income "be deemed working capital requirements." In order to comply with A.R.S. Section 40-302(A), the Application stated that "[t]o the extent that the purposes set forth herein may be considered reasonably chargeable to operating expenses or to income, the Company requests that the order or orders of the Commission in this matter authorize such charge or charges." (Application at 9.) The Company respectfully requests that the Commission's order in this matter not include language regarding "deemed working capital requirements" because not all the uses to which cash proceeds from the requested financing order would potentially be used can be classified as "working capital."

14. The Staff Report references a "waiver now in existence (per Decision Nos. 65796 and 55017) of A.A.C. R14-2-803" (Staff Report at 2) in connection with its recommendation that the Commission "[authorize] Pinnacle West to guarantee APS' debt from time to time in indeterminate amounts" (Staff Report at 7). No such waiver was granted to Pinnacle West in either of the cited Decisions, but Pinnacle West supports the Staff's recommendation.

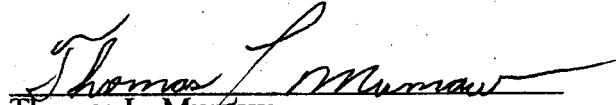
1 15. The Staff Report recommends that, "on each occasion when APS enters into a new  
2 long-term debt agreement, APS file with Docket Control a description of the transaction  
3 and a demonstration that the rates and terms are consistent with those generally available  
4 to comparable entities at the time." (Staff Report at 7.) Recognizing that the Staff Report  
5 also recommends that the Commission deny APS' request for a declaratory order  
6 confirming that only traditional indebtedness for borrowed money requires Commission  
7 approval (Staff Report at 5), APS assumes that the Staff's filing recommendation would  
8 cover any transaction classified as long-term debt from a GAAP perspective, regardless of  
9 its nature or size. If so, APS believes that such a requirement will result in filings for  
10 transactions in which the Commission presumably will have little or no interest and which  
11 will require APS time and expense to prepare. For example, every capital lease with a  
12 term of 12 months or longer that APS enters into would be subject to the filing  
13 requirement, including capital leases for vehicles, equipment, and copy machines. APS  
14 requests that such filing requirement be limited to long-term debt agreements involving  
15 traditional indebtedness for borrowed money. In addition, APS requests that such filing  
16 requirement exclude any long-term debt agreement that has a principal value of less than  
17 \$5 million. As is the case with non-traditional indebtedness, APS believes that including  
18 immaterial debt agreements among the required filings will result in filings for  
19 transactions in which the Commission presumably will have little or no interest on an  
20 individual basis and which will require APS time and expense to prepare.

21 16. The Staff Report "further recommends authorization of the other financing requests  
22 made by APS in this application except as otherwise specified [in the Staff Report]."  
23  
24  
25  
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28

1 (Staff Report, Executive Summary.) Consistent with the Staff's position in this regard, as  
2 well as the Company's suggested modifications and clarifications above, the Company  
3 has attached as Exhibit F to this filing proposed language for a Commission Order in this  
4 matter, including alternative language in those cases in which the Company has suggested  
5 different approaches to the resolution of a specific issue.  
6

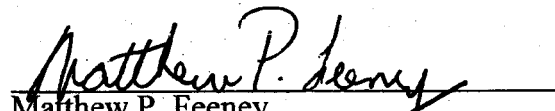
7  
8 RESPECTFULLY SUBMITTED this 29<sup>th</sup> day of May, 2007.

9 By:

  
Thomas L. Murraw

11 ATTORNEY FOR ARIZONA PUBLIC  
12 SERVICE COMPANY

13 By:

  
Matthew P. Feeney  
Snell & Wilmer, L.L.P.

15 ATTORNEY FOR PINNACLE WEST  
16 CAPITAL CORPORATION  
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1 ORIGINAL and 13 copies filed with  
2 Docket Control this 29<sup>th</sup> day of May 2007.

3 COPIES hand-delivered this 29<sup>th</sup> day of  
4 May 2007, to:

5 Mr. Christopher C. Kempley  
6 Chief Counsel, Legal Division  
7 Arizona Corporation Commission  
8 1200 West Washington Street  
9 Phoenix, Arizona 85007

10 Mr. Ernest G. Johnson  
11 Director, Utilities Division  
12 Arizona Corporation Commission  
13 1200 West Washington Street  
14 Phoenix, Arizona 85007

15 Ms. Lyn Farmer  
16 Chief Administrative Law Judge, Hearing Division  
17 Arizona Corporation Commission  
18 1200 West Washington Street  
19 Phoenix, Arizona 85007  
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**EXHIBITS**

- Exhibit A**      **Calculations of Arizona Public Service Company's Common Equity Percentages at March 31, 2007, Using Alternative Approaches.**
- Exhibit B**      **Calculation of Arizona Public Service Company's DSC and proposed Modified DSC at December 31, 2006.**
- Exhibit C**      **Issues Regarding the DSC Requiring Commission Resolution.**
- Exhibit D**      **Arizona Corporation Commission Order in Decision No. 55120, dated July 24, 1986.**
- Exhibit E**      **Arizona Corporation Commission Order in Decision No. 55320, dated December 5, 1986.**
- Exhibit F**      **Certain Language for Proposed Order.**

EXHIBIT A

ARIZONA PUBLIC SERVICE COMPANY  
Calculation of Common Equity Test  
Per ACC Order No. 65796 Dated April 4, 2003  
As of March 31, 2007  
(\$000)

ARIZONA PUBLIC SERVICE COMPANY  
Calculation of Common Equity Test  
Per ACC Staff Report in Docket No. E-01345A-06-0779  
As of March 31, 2007  
(\$000)

Common Equity	\$ 3,202,664 A	Common Equity	\$ 3,202,664 A
Long Term Debt less Current Maturities	2,877,377	Long Term Debt less Current Maturities	2,877,377
Current Maturities of Long Term Debt	1,049	Current Maturities of Long Term Debt*	1,049
--	-	Short Term Debt	-
Total Long Term Debt	\$ 2,878,426	Total Debt	\$ 2,878,426
Total Capitalization	\$ 6,081,090 B	Total Capitalization	\$ 6,081,090 B
Common Equity Ratio	52.7% A/B	Common Equity Ratio	52.7% A/B

\* Staff Report does not specifically list Current Maturities of Long Term Debt as being included in this calculation. We assume it's included in Staff's definition of long term debt.



EXHIBIT B

ARIZONA PUBLIC SERVICE COMPANY  
Calculation of Debt Service Coverage Ratio <sup>(1)</sup>  
Twelve Months Ended December 31, 2006  
(\$000)

Operating Income	\$ 397,942
Depreciation & Amortization	353,057
Income Taxes	144,127
Cash Flow	<u>\$ 895,126 A</u>
Long-Term Principal Repayments	\$ 86,086
Short-Term Principal Repayments	-
Long-Term Interest	149,240
Short-Term Interest	9,529
Less:	
Short-Term Debt for Natural Gas and Purchased Power (PP)	-
Interest on Short-Term Debt for Natural Gas and PP	-
Plus:	
Principal on New Short-Term Debt	-
Interest on New Short-Term Debt	-
Principal on New Long-Term Debt	-
Interest on New Long-Term Debt	-
Total Principal & Interest	<u>\$ 244,855 B</u>

Debt Service Coverage Ratio 3.66 A/B

ARIZONA PUBLIC SERVICE COMPANY  
Calculation of Modified Debt Service Coverage Ratio  
Twelve Months Ended December 31, 2006  
(\$000)

Operating Income	\$ 397,942
Depreciation & Amortization	353,057
Income Taxes	144,127
Cash Flow	<u>\$ 895,126 A</u>
Long-Term Interest	149,240
Short-Term Interest	9,529
Plus:	
Interest on New Short-Term Debt <sup>(2)</sup>	-
Interest on New Long-Term Debt <sup>(3)</sup>	-
Total Interest	<u>\$ 158,769 B</u>

Modified Debt Service Coverage Ratio 5.64 A/B

Notes:

(1) See Exhibit C for list of questions in order to calculate this ratio.

(2) The interest impact of changes to outstanding short-term debt to the date of calculation, calculated as the annualized interest at the actual interest rate on any new short-term debt issued after the 12 month period covered by the applicable audited financial statements and remaining outstanding on the date of calculation.

(3) The interest impact of changes to outstanding long-term debt to the date of calculation, calculated as the annualized interest at the actual interest rate on any new long-term debt issued after the 12 month period covered by the applicable audited financial statements and remaining outstanding on the date of calculation plus the new annualized interest at the expected interest rate on the new long-term debt to be issued or incurred and for which the DSC calculation is being made.

Exhibit C

**Issues Regarding the DSC Requiring Commission Resolution**

Questions regarding principal on long-term and short-term debt:

1. Are maturities of long-term debt that existed during the prior calendar year to be included, even if the principal on such debt has already been repaid?
2. Does APS assume that the short-term debt balance that exists at the prior year-end is to be repaid, even if those balances may be rolled over?
3. Does APS include maturities of long-term debt that are expected to be paid during the upcoming calendar year?
4. Since new long-term debt is usually issued prior to the maturity date of an existing long-term debt series, does APS net the new long-term debt against the matured/repurchased long-term debt during the upcoming calendar year?
5. If the new long-term debt issuance occurs before the calendar year of the matured/repurchased long-term debt but the use of proceeds in the financing prospectus identifies the purpose as repaying the maturing long-term debt, does APS net the new long-term debt against the maturing long-term debt?
6. Since short-term debt is often incurred prior to the issuance of new long-term debt, does APS assume maturing short-term debt and new long-term debt can be netted against each other?

Questions Regarding "Subsequent Adjustments":

7. The footnote definition of DSC states that the DSC calculation is "adjusted to reflect changes to outstanding debt".

- (a) Does this include long-term and short-term debt?
- (b) Does it include both increases and decreases to debt balances?
- (c) Is it meant to cover both principal and interest?
- (d) If long-term debt does not mature for several years and no principal payments are required until maturity, does that principal payment need to be added?
- (e) If interest is to be added, should it be annualized?
- (f) What rate of interest should be used for short-term debt that has been issued at various points in time?

8. APS must satisfy the DSC "subsequent to any debt issuance."

- (a) Does APS do a pro-forma calculation that would add the principal and annualized interest on the impending debt issuance?
- (b) Please respond to questions 7(a), 7(c), 7(d) and 7(e) in regard to the pro-forma calculation of principal and interest.

Questions regarding the phrase "less short-term debt related to purchased power and natural gas" in the definition of DSC:

9. How should APS calculate the interest offset for short-term debt related to purchased power and natural gas costs?

BEFORE THE ARIZONA CORPORATION COMMISSION

RENE D. JENNINGS  
CHAIRMAN  
MARCIA WEEKS  
COMMISSIONER  
SHARON S. MEGDAL  
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF  
ARIZONA PUBLIC SERVICE COMPANY FOR AN  
ORDER OR ORDERS: (1) AUTHORIZING IT TO  
ENTER INTO VARIOUS TRANSACTIONS AND  
AGREEMENTS RELATING TO THE SALE AND  
OPERATING LEASE OF ALL OR A PORTION OF  
THE COMPANY'S UNDIVIDED OWNERSHIP  
INTEREST IN UNIT 2 OF THE PALO VERDE  
NUCLEAR GENERATING STATION AND CERTAIN  
COMMON FACILITIES; (2) AUTHORIZING IT  
TO ISSUE OR INCUR EVIDENCES OF INDEBTED-  
NESS IN CONNECTION THEREWITH; (3) CON-  
FIRMING THAT THE OWNER TRUSTEE AND THE  
EQUITY INVESTORS WILL NOT BE "PUBLIC  
SERVICE CORPORATIONS"; (4) CONFIRMING  
THAT THE LEASES WILL BE "OPERATING  
LEASES" FOR ACCOUNTING PURPOSES; AND,  
(5) DESCRIBING THE RATE-MAKING  
TREATMENT OF THE PROPOSED TRANSACTIONS.

DOCKET NO. 0-1345-86-105

DECISION NO. 55220

Arizona Corporation Commission

DOCKETED

JUL 24 1986

DOCKETED BY	<i>lms</i>
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OPINION AND ORDER

DATE OF HEARING: July 10, 1986

PLACE OF HEARING: Phoenix, Arizona

PRESIDING OFFICER: Thomas L. Nunnaw, Chief Hearing Officer

IN ATTENDANCE: Rene D. Jennings, Chairman  
Marcia Weeks, Commissioner  
Sharon S. Magdal, Commissioner

APPEARANCES: Jaron E. Norberg, Senior Vice President and Corporate  
Counsel, Raymond Heyman, and Snell & Wilmer,  
by Steven H. Wheeler, Attorneys for Arizona Public  
Service.

Elizabeth Kushibab, Attorney, Legal Division, for  
the Arizona Corporation Commission Staff

Steven Avilla, Attorney, for the Residential Utility  
Consumer Office

27 . . .

28 . . .

1 BY THE COMMISSION:

2 On April 22, 1986, Arizona Public Service Company ("APS" or "Company")  
3 filed an Application with the Commission requesting an Order authorizing the  
4 Company, among other things, to enter into various transactions and agreements  
5 relating to the sale and operating lease of all or a portion of the Company's  
6 undivided ownership interest in the Palo Verde Unit 2 Facilities as hereinafter  
7 defined.

8 On April 27, and May 21, 1986, the Coalition for Responsible Energy  
9 Education ("CREE") and the Residential Utility Consumer Office ("RUCO") filed  
10 Petitions to Intervene herein. Both said Petitions were granted by Procedural  
11 Order prior to the scheduled hearing on APS's Application.

12 Pursuant to Notice dated June 26, 1986, APS's Application came on for  
13 hearing before a duly authorized Hearing Officer of the Commission at its  
14 offices in Phoenix, Arizona, on July 10, 1986. APS, RUCO, and the  
15 Commission's Utilities Division Staff ("Staff") appeared through counsel, and  
16 each presented testimony and exhibits in support of APS's Application. At the  
17 conclusion of a full public hearing, this matter was adjourned pending  
18 submission of a Recommended Opinion and Order by the Presiding Officer to the  
19 Commission.

20 DISCUSSION

21 As indicated above, both Staff and Intervenor RUCO supported the  
22 Application. Staff did propose various reporting requirements which would keep  
23 the Commission informed as to the details of the sale and leaseback (as well as  
24 any material changes in the transaction both prior to and after closing), and  
25 suggested that proceeds derived from such sale and leaseback be placed in a  
26 separate interest bearing bank account. Staff and RUCO further recommended  
27 that the Commission be circumspect in its language approving this matter so as  
28 to retain its flexibility to disallow all or part of the operating lease

1 payments from APS's cost of service in its pending rate proceeding (Docket No.  
2 U-1345-85-367). Finally, NUCO noted that recoverability of these lease  
3 payments in rates should be subject to performance criteria, and that it would  
4 be proposing such criteria in the aforementioned rate Docket.

5 As in Docket No. U-1933-86-036, decided this same day, we will adopt  
6 Staff's reporting requirements and will use the same language generally  
7 disclaiming any prior judgment on the recoverability through rates of these  
8 operating lease payments.<sup>1</sup> We also agree that performance criteria for Palo  
9 Verde are appropriate. See Decision No. 55118 in Docket No. U-1345-85-156  
10 (Phase I), also decided this day. We will not require that APS separately  
11 deposit the funds received through the sale and leaseback transaction.  
12 However, periodic reporting on APS's use of such proceeds will serve to  
13 reassure the Commission that the limitations on their use both agreed to by APS  
14 and ordered hereinafter are being properly observed.

15 \* \* \* \* \*

16 Having considered the entire record herein and being fully advised in the  
17 premises, the Commission finds, concludes and orders that:

18 FINDINGS OF FACT

19 1. APS is an Arizona corporation engaged in providing electric service  
20 within various portions of Arizona pursuant to authority granted by this  
21 Commission.

22 2. By its Application and testimony in this matter, the Company  
23 requests one or more orders granting the following:

- 24 (a) authorization to refinance its construction financing for  
25 Unit 2 of the Palo Verde Nuclear Generating Station  
26 ("Palo Verde") by entering into one or more sale and leaseback  
27 transactions (the "Lease Transactions") relating to (1) all or

28 <sup>1</sup> Similar language is included in all Commission Decisions authorizing  
financing transactions.

a portion of the Company's 29.1% undivided ownership interest in Unit 2, including, without limitation, all or a portion of the Company's generation entitlement share in Unit 2 and (ii) certain real property interests in the Palo Verde plant site and related real property (such interest in Unit 2 and the real property interests being hereinafter collectively referred to as the "Unit 2 Facilities");

(b) authorization for the Company to issue, assume, guarantee, or incur evidences of indebtedness in connection with the Lease Transactions;

(c) confirmation that the Leases (as hereinafter defined) will be treated as "operating leases" for accounting and rate-making purposes;

(d) confirmation of the rate-making treatment of the Lease Transactions; and,

(e) confirmation that the Lessors and the Equity Investors (as hereinafter defined) will not be "public service corporations" subject to regulation under Arizona law by reason of their holding title to, or possessing an interest in, the Unit 2 Facilities.

3. The Lease Transactions will involve the Company's sale of the Unit 2 Facilities to, and then the lease of the Unit 2 Facilities back from, institutional investors ("Equity Investors").

4. Each of the Equity Investors will form a trust for the purpose of holding title to its undivided interest in the Unit 2 Facilities, and the trustees under the trusts will act as lessors ("Lessors") of the Unit 2

...

...

Facilities and will lease the Unit 2 Facilities to APS under one or more leases ("Leases").

5. If the Lease Transactions are completed as to less than all of APS's interest in the Unit 2 Facilities, APS will retain an undivided ownership interest in the remainder of the Unit 2 Facilities.

6. The Unit 2 Facilities will be sold to the lessors at a fair market price, and prior to the closing of the Lease Transactions, an appraisal will confirm that the purchase price is a reasonable estimate of fair market value in order to comply with certain Internal Revenue Service requirements to preserve certain tax benefits of the transactions.

7. APS's profit on the sale at fair market value of the Unit 2 Facilities (net of associated income tax) will be amortized as a credit against APS's operating lease expense over the term of the lease.

8. Lessors will borrow approximately 70% to 80% of the purchase price from a funding corporation (the "Funding Corporation") formed for that purpose, and the Funding Corporation, in turn, will borrow the debt portion of the purchase price by issuing debt that will be non-recourse to the Lessors and the Equity Investors.

9. The debt referred to in Finding of Fact No. 8, hereinabove, will be indirectly secured by an assignment of the rentals and other payments due from the Company under the Leases.

10. APS will be named the "Registrant" in any Registration Statement filed with the Securities and Exchange Commission in connection with the issuance of such debt.

11. Upon the occurrence of certain events to be described in the leases, APS will be required to assume the Lessors' debt to the Funding Corporation.

12. Throughout the terms of the Leases, APS may direct the Lessors to refund the Lessors' debt to the Funding Corporation at then prevailing interest



1 rates, with net benefits of such refunding to be reflected in the Company's  
2 rental payments under the Leases.

3 13. Financial support in the form of letters of credit or financial  
4 guarantees will also be obtained to secure the Equity Investors for the payment  
5 of amounts by the Company under the leases and related documents, and APS may  
6 be required to issue or incur evidences of indebtedness in connection with such  
7 financial support.

8 14. Although the Lessors will be the owners of the Unit 2 Facilities,  
9 APS will remain responsible for all expenses of operation and maintenance.

10 15. The initial term of the Leases will be approximately 29-1/2 years,  
11 and the Company will have certain renewal options.

12 16. APS will have certain options to repurchase the Unit 2 Facilities.

13 17. The rent to be paid by APS over the term of the Leases will be a  
14 function of the interest rates payable on the debt issued by the Funding  
15 Corporation, the purchase price, marginal tax rates, etc.

16 18. Throughout the term of the Leases, APS will be required with respect  
17 to the Unit 2 Facilities to be and to act as a "participant" under the ANEP  
18 Participation Agreement, as amended, which governs the construction, operation,  
19 and maintenance of Palo Verde and the rights and duties of the joint owners of,  
20 and participants in Palo Verde.

21 19. The Company will also continue to serve as "Operating Agent" of Unit  
22 2 responsible to the other Palo Verde participants, and as the sole licensee  
23 responsible to the Nuclear Regulatory Commission (the "NRC"), for the use and  
24 operation of Unit 2, including decommissioning.

25 20. Although APS will remain liable for its share of the decommissioning  
26 cost of Unit 2 under NRC regulations, the Lease Transactions may require the  
27 Equity Investors to fund a portion of the estimated costs of decommissioning  
28 the portion of the Unit 2 Facilities acquired by the Equity Investors.

21. Any addition, betterment, or enlargement of the Unit 2 Facilities, or replacement of units of the property within the Unit 2 Facilities ("Capital Improvements") will be APS's obligation under the Leases.

22. APS may, but will not be obligated to, request that the Lessors provide financing under the Leases ("Supplemental Financings") for their respective shares of Capital Improvements.

23. The terms and conditions of Supplemental Financing will be subject to mutual agreement between the Company and each Equity Investor, and each Equity Investor will have the option, but no obligation, to make additional equity investments in Capital Improvements that are the subject of Supplemental Financings.

24. If any such Capital Improvement is not funded by an Equity Investor, such Equity Investor will, subject to certain conditions, permit the Lessor to borrow additional funds from the Funding Corporation in an amount sufficient to fund such Equity Investor's share of the Capital Improvement.

25. Concurrently with any Supplemental Financings, the rent payments will be adjusted to support the amortization of the additional debt issued in connection with the Supplemental Financing and to preserve the Equity Investors' net economic return.

26. The Company and the Lessors will enter into support agreements that will provide the Lessors with such rights in parts of the company's interest in Palo Verde not constituting Unit 2 Facilities as may be necessary to enable the Lessors and their successors and assigns to realize the residual values of their interests under the Lease Transactions that may be consummated.

27. The proposed Leases will be "operating leases" as defined in accordance with generally accepted accounting principles, and for rate-making purposes the aggregate amount of Lease payments will be accounted for by the Company as an operating and maintenance expense, with the recoverability of

such Lease payments through rates to be decided in Docket U-1345-85-367.

28. APS intends to use the net proceeds from the Lease Transactions for the redemption, retirement, or refunding of outstanding long-term debt and/or preferred stock that previously financed construction projects and, if necessary, the satisfaction of certain of the Company's working capital and other cash requirements, including the financing of APS's ongoing construction program.

29. The payments under the Leases will be chargeable to the Company's operative expenses or to income.

30. The issuance, assumption, guarantee, or incurrence of evidences of indebtedness by the Company in connection with the Lease Transactions will be for the purpose of allowing the company to perform its obligations and/or exercise its options under the Lease Transactions.

31. It has been estimated by Staff and APS that the expected present value savings to ratepayers resulting from the Lease Transactions will range from roughly \$10,000,000 to \$128,000,000.

32. The above savings assume the subtraction from APS's rate base of all tax credits generated by the Lease Transactions and retained by APS, subject to retatable restoration over a 35 year period.

33. The Lease Transactions and the issuance, assumption, guarantee, or incurrence of evidences of indebtedness in connection therewith are compatible with the public interest, with sound financial practices, and with the proper performance by the Company of service as a public service corporation and will not impart its ability to perform that service.

34. The Lease Transactions and the issuance, assumption, guarantee, or incurrence of evidences of indebtedness in connection therewith are reasonably necessary or appropriate for the purposes set forth herein and, except as otherwise set forth herein, are not, wholly or in part, reasonably chargeable

1 to the Company's operative expenses or to income.

2 35. Performance criteria are specifically required in order to assure  
3 that ratepayers pay only the allowable costs under efficient operations. The  
4 Commission expects the parties to present such performance criteria in the rate  
5 case involving the sale and leaseback.

6 CONCLUSIONS OF LAW

7 1. APS is a public service corporation within the meaning of Article XV  
8 of the Arizona Constitution and A.R.S. §§ 40-285 and 40-301, et seq.

9 2. The Commission has jurisdiction over APS and of the subject matter  
10 of the Application.

11 3. The proposed Lease Transactions and the issuance, assumption,  
12 guarantee, or incurrence of evidences of indebtedness in connection therewith,  
13 as well as the other matters set forth in the Application, exhibits, and  
14 testimony relating to this matter are for lawful purposes within the corporate  
15 powers of APS and are compatible with the public interest.

16 4. APS's leasehold interest in the Unit 2 Facilities, including its  
17 contractual rights under said Leases, shall be subject to the Commission's  
18 authority under A.R.S. § 40-285(A).

19 ORDER

20 IT IS THEREFORE ORDERED that Arizona Public Service Company is hereby  
21 authorized:

- 22 (a) to undertake and consummate the Lease Transactions and to  
23 take all such actions as may be necessary or appropriate in  
24 connection therewith, subject to the limitations and conditions  
25 contained in this Decision;
- 26 (b) to issue, assume, guarantee, and incur evidences of indebtedness  
27 in order to consummate, and to perform its obligations and exercise  
28 its options under, the Lease Transactions (including the issuance

1 or incurrence of evidences of indebtedness in connection with the  
2 financing of Capital Improvements as required or permitted by the  
3 terms of the leases, the costs of which will be reflected in an  
4 adjustment to lease rentals) including, but not limited to, (i) the  
5 issuance or incurrence of evidences of indebtedness by the Funding  
6 Corporation, secured by the direct obligation of the Company; (ii)  
7 the issuance or incurrence of evidences of indebtedness in  
8 connection with any letter of credit or financial guarantee securing  
9 the Equity Investors for the payment of amounts payable by the  
10 Company under the Lease and related documents; (iii) the issuance  
11 or incurrence of evidences of indebtedness necessary for any  
12 refunding of indebtedness; (iv) the assumption of indebtedness  
13 by the Company upon the occurrence of certain events as  
14 required by the leases; (v) the adjustment of rents from time  
15 to time as required by the leases; and (vi) the execution of  
16 supplements to the Lease as required or permitted by the  
17 leases; and

18 (c) to exercise its options to renew the Leases and to repurchase  
19 all or any portion of the Unit 2 Facilities in accordance with  
20 the terms of the Leases.

21 IT IS FURTHER ORDERED that the Leases will be treated as operating leases  
22 for both accounting and rate-making purposes and that the aggregate amount of  
23 Lease payments will be accounted for by the Company as an operating and  
24 maintenance expense.

25 IT IS FURTHER ORDERED that all profit from the sale of the Unit 2  
26 Facilities (less associated income tax) should be amortized over the initial  
27 term of the lease as a credit against such lease expense.

28 IT IS FURTHER ORDERED that Arizona Public Service Company shall treat any

1 tax credits generated by the sale of the Unit 2 Facilities and retained by the  
2 Company as an offset (deduction) against its "fair value" rate base, subject to  
3 restorable restoration over a 35 year period.

4 IT IS FURTHER ORDERED that approval of the requested Lease Transactions as  
5 set forth in the Application and authorized hereinabove does not constitute or  
6 imply approval or disapproval by the Commission of any particular expenditure  
7 for purposes of establishing just and reasonable rates.

8 IT IS FURTHER ORDERED that Arizona Public Service Company shall file a  
9 Plan of Disposition with the Commission within thirty (30) days of the entry of  
10 this Decision, which Plan shall indicate the use to be made of the proceeds  
11 derived from the transactions authorized herein over the succeeding twelve (12)  
12 month period.

13 IT IS FURTHER ORDERED that Arizona Public Service Company shall thereafter  
14 annually update such Plan and shall keep the Commission informed of any  
15 material change in said Plan.

16 IT IS FURTHER ORDERED that the purposes for which the proposed Lease  
17 Transactions are herein authorized are to redeem, retire, or refund outstanding  
18 long-term debt and/or preferred stock that previously financed construction  
19 projects and, if necessary, to satisfy certain of the Company's working capital  
20 and other cash requirements, including the financing of Arizona Public Service  
21 Company's ongoing construction program, regardless of the extent to which such  
22 purposes may be reasonably chargeable to operative expenses or income.

23 IT IS FURTHER ORDERED that the purpose for which the proposed issuance,  
24 assumption, guarantee, or incurrence of evidences of indebtedness in connection  
25 with the Lease Transactions is herein authorized is to allow Arizona Public  
26 Service Company to perform its obligations and/or exercise its options under  
27 the Lease Transactions, which purpose is hereby specifically authorized  
28 regardless of the extent to which it may be reasonably chargeable to operative

1 expenses or to income.

2 IT IS FURTHER ORDERED that the terms of the Leases and other documents to  
3 be entered into in connection with the Lease Transactions are hereby approved  
4 for the specific purpose of enabling each of the Equity Investors and the  
5 Lessors to qualify for an exemption by the Securities and Exchange Commission  
6 from the Public Utility Holding Company Act of 1935, as amended.

7 IT IS FURTHER ORDERED that Arizona Public Service Company's assumption,  
8 guaranties, and incurrence of evidences of indebtedness as herein authorized  
9 shall be separate and apart from, and not counted against, Arizona Public  
10 Service Company's existing Debt limitation, or against such limitation as it  
11 may be hereafter modified by the Commission, that limitation presently being  
12 \$2,698,917,000, as approved in the Commission's Order in Decision No. 95017  
13 (May 6, 1986).

14 IT IS FURTHER ORDERED that the Commission hereby declares that the Lease  
15 Transactions will not cause any of the Equity Investors or the Lessors to be  
16 deemed to be a "public service corporation" subject to the jurisdiction,  
17 control, or regulation of the Commission under current provisions of Article XV  
18 of the Arizona Constitution.

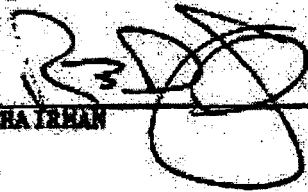
19 IT IS FURTHER ORDERED that Arizona Public Service Company shall file with  
20 the Commission any and all documents executed pursuant to the authorizations  
21 granted hereinabove (including amendments to such documents executed subsequent  
22 to closing) within five (5) business days of their execution, or with regard to  
23 those documents executed prior to the effective date of this Decision, within  
24 five (5) business days of such date.

25 IT IS FURTHER ORDERED that Arizona Public Service Company shall notify the  
26 Commission of any material changes in the terms and conditions of the sale and  
27 leaseback transaction authorized hereinabove as soon as is reasonably possible,  
28

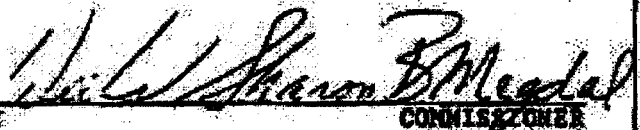
1 but in any event, at least five (5) business days prior to the closing date.

2 IT IS FURTHER ORDERED that this Decision shall become effective  
3 immediately.

4 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

5   
6 CHAIRMAN

7   
8 COMMISSIONER

9   
10 COMMISSIONER

11 IN WITNESS WHEREOF, I, JAMES MATTHEWS,  
12 Executive Secretary of the Arizona  
13 Corporation Commission, have hereunto set my  
14 hand and caused the official seal of this  
15 Commission to be affixed at the Capitol, in  
16 the City of Phoenix, this 24 day  
17 of July, 1986.

18   
19 JAMES MATTHEWS  
20 Executive Secretary

21 DISSENT \_\_\_\_\_  
22 TLM/djp  
23  
24  
25  
26  
27  
28



BEFORE THE ARIZONA CORPORATION COMMISSION

RENZ D. JENNINGS  
Chairman  
MARCIA WEEKS  
Commissioner  
SHARON B. MEGDAL  
Commissioner

IN THE MATTER OF THE APPLICATION OF )  
ARIZONA PUBLIC SERVICE COMPANY FOR AN )  
ORDER OR ORDERS (1) AUTHORIZING IT TO )  
ENTER INTO VARIOUS TRANSACTIONS AND )  
AGREEMENTS RELATING TO THE SALE AND )  
OPERATING LEASE OF ALL OR A PORTION OF )  
THE COMPANY'S UNDIVIDED OWNERSHIP )  
INTEREST IN UNIT 2 OF THE PALO VERDE )  
NUCLEAR GENERATING STATION AND CERTAIN )  
COMMON FACILITIES; (2) AUTHORIZING IT )  
TO ISSUE OR INCUR EVIDENCES OF )  
INDEBTEDNESS IN CONNECTION THEREWITH; )  
(3) CONFIRMING THAT THE OWNER TRUSTEE )  
AND THE EQUITY INVESTORS WILL NOT BE )  
"PUBLIC SERVICE CORPORATIONS"; )  
(4) CONFIRMING THAT THE LEASES WILL BE )  
"OPERATING LEASES" FOR ACCOUNTING )  
PURPOSES; AND (5) DESCRIBING THE RATE- )  
MAKING TREATMENT OF THE PROPOSED )  
TRANSACTIONS. )

DOCKET NO. U-1345-86-105

DECISION NO. 55320

ORDER

Arizona Corporation Commission  
**DOCKETED**

DEC - 5 1986

Open Meeting  
December 3, 1986  
Phoenix, Arizona

DOCKETED BY

C.M.

BY THE COMMISSION:

On November 17, 1986, Arizona Public Service Company (the "Company") filed a Motion with the Commission requesting the Commission to issue an order confirming that (i) the Commission's order in Decision No. 55120, dated July 24, 1986, (the "Order") authorizes the Company to enter into Additional Lease Transactions (as hereinafter defined) and (ii) all other aspects of the Order, including, without limitation, the limitation and conditions, authorizations, statutory findings, and conclusions of law set forth therein, are applicable to Additional Lease Transactions.

...

• \* \* \* \* \*

1  
2 Having considered the Motion, and being fully advised in the premises, the

3 Commission finds, concludes, and orders that:

4 FINDINGS OF FACT

5 1. The Company is an Arizona corporation engaged in providing electric  
6 service to the public within portions of Arizona pursuant to authority granted  
7 by this Commission.

8 2. On April 22, 1986, the Company filed an Application with the  
9 Commission requesting, among other things, authorization to enter into one or  
10 more sale and leaseback transactions relating to all or a portion of the  
11 Company's 29.1% undivided ownership interest in the Unit 2 Facilities (as  
12 hereinafter defined).

13 3. On July 24, 1986, the Commission issued the Order authorizing the  
14 Company, among other things, to "undertake and consummate the Lease  
15 Transactions and to take all such actions as may be necessary or appropriate in  
16 connection therewith, subject to the limitations and conditions contained in  
17 this Decision". The Order defines "Lease Transactions" as "one or more sale  
18 and leaseback transactions relating to (i) all or a portion of the Company's  
19 29.1% undivided ownership interest in Unit 2, including, without limitation,  
20 all or a portion of the Company's generation entitlement share in Unit 2 and  
21 (ii) certain real property interests in the Palo Verde plant site and related  
22 real property (such interest in Unit 2 and the real property interests being  
23 hereinafter collectively referred to as the 'Unit 2 Facilities')".

24 4. Pursuant to the authorization contained in the Order, on  
25 August 18, 1986, the Company sold and leased back approximately 30.7% of its  
26 29.1% undivided ownership interest in the Unit 2 Facilities (the "Initial Lease  
27 Transactions"). The total consideration to the Company from the Initial Lease  
28 Transactions was \$341,240,000.

1           5.    ~~The Company is currently evaluating additional Lease Transactions~~  
2 relating to its remaining undivided ownership interest in the Unit 2 Facilities  
3 ("Additional Lease Transactions"), including Additional Lease Transactions that  
4 the Company proposes to consummate on or about December 15, 1986. Unlike the  
5 Initial Lease Transactions, the proposed December 1986, Lease Transactions may  
6 not include a letter of credit issued in favor of the equity investors and may  
7 include a portion of the Company's interest in certain common facilities  
8 associated with the operation of Unit 2. Another feature of the Initial Lease  
9 Transactions, a stepped-up investment tax, will not be available in Additional  
10 Lease Transactions.

11           6.    By its Motion, the Company requests the Commission to issue an order  
12 confirming that (i) the Order authorizes the Company to enter into Additional  
13 Lease Transactions and (ii) all other aspects of the Order, including, without  
14 limitation, the limitations and conditions, authorizations, statutory findings,  
15 and conclusions of law therein, are applicable to Additional Lease  
16 Transactions.

17           7.    The Company is requesting the Commission to confirm that the Order  
18 authorizes Additional Lease Transactions in order to provide potential lenders  
19 and investors with the required explicit assurance that Commission approval for  
20 the transactions has been obtained. Because the testimony in the  
21 July 10, 1986, Commission hearing relating to the Lease Transactions discussed  
22 the Initial Lease Transactions that were to take place the following month in  
23 more detail than the possibility of Additional Lease Transactions, it is  
24 conceivable that the Order may be improperly construed to authorize only the  
25 Initial Lease Transactions.

26           8.    The Additional Lease Transactions were approved in the Order to the  
27 same extent the Initial Lease Transactions were. They are also subject to the  
28 same limitations and conditions. Pursuant to the requirements of the

1 Order, the Company will file with the Commission (i) all documents executed  
2 pursuant to the authorizations granted by the Order, including such documents  
3 executed in connection with any Additional Lease Transactions, (ii) a plan of  
4 disposition indicating the use to be made of the proceeds derived from any  
5 Additional Lease Transactions, and (iii) at least five (5) days prior to  
6 closing, notification of any material changes in the Lease Transactions  
7 authorized by the Order.

8 9. The recoverability of the Company's lease payments under any  
9 Additional Lease Transactions will be decided in Docket No. U-1345-85-367.

10 ORDER

11 IT IS THEREFORE ORDERED that this Commission hereby

12 (i) confirms that the Order authorizes Additional Lease Transactions;

13 (ii) confirms that all other aspects of the Order, including, without  
14 limitation, the limitations and conditions, authorizations, statutory  
15 findings, and conclusions of law set forth therein, are applicable to  
16 Additional Lease Transactions.

17 IT IS FURTHER ORDERED that, without limiting the foregoing confirmation,  
18 approval of the Additional Lease Transactions does not constitute or imply  
19 approval or disapproval by the Commission of any particular expenditure for  
20 purposes of establishing just and reasonable rates.

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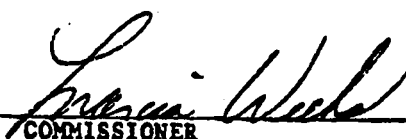
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IT IS FURTHER ORDERED that this Decision shall become effective immediately.

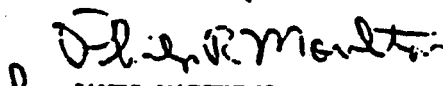
BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

  
CHAIRMAN

  
COMMISSIONER

COMMISSIONER

IN WITNESS WHEREOF, I, JAMES MATTHEWS, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of this Commission to be affixed at the Capitol, in the City of Phoenix, this 5<sup>th</sup> day of December, 1986.

  
for JAMES MATTHEWS  
Executive Secretary

DISSENT  
TLM/sks

EXHIBIT F

PROPOSED LANGUAGE FOR ORDER

[Capitalized terms used in the paragraphs below and not otherwise defined are intended to have the meanings given in the Application.]

IT IS THEREFORE ORDERED that the Company is hereby authorized (i) to issue, sell, and incur the Continuing Long-Term Debt and the Continuing Short-Term Debt, as such term is defined below, redeem, refinance, refund, renew, reissue, roll-over, repay, and re-borrow from time to time such Continuing Long-Term Debt and Continuing Short-Term Debt, and establish and amend the terms and provisions of long-term and short-term indebtedness from time to time, (ii) to determine the form of security, if any, for the Continuing Long-Term Debt and the Continuing Short-Term Debt, execute and deliver the Security Instruments, and establish and amend the terms and provisions of the Security Instruments, as may be deemed appropriate by the Company in connection with the Continuing Long-Term Debt and the Continuing Short-Term Debt, and (iii) to pay all related expenses, all as contemplated in the Application and by the exhibits and testimony presented during the hearing in this matter.

IT IS FURTHER ORDERED that the Company is authorized to issue short-term debt at any time and from time to time (excluding current maturities of long-term debt) in an amount not to exceed 7% of the Company's capitalization plus up to an additional \$500 million for purchases of natural gas and power. (All short-term indebtedness outstanding on the date of this Order or hereafter issued or incurred pursuant to this paragraph is referred to as "Continuing Short-Term Debt.")

IT IS FURTHER ORDERED that prior to the issuance or incurrence of the up to \$500 million of short-term debt relating to purchases of natural gas and power, the Company must have a Commission authorized adjustor mechanism for recovery of natural gas or power purchases and, if such mechanism is terminated, the authorization for the additional \$500 million of short-term debt will terminate 12 months thereafter.

IT IS FURTHER ORDERED that if all or a portion of the authorized short-term debt relating to natural gas and power purchases becomes classified as long-term debt because the amount remains outstanding for more than 12 months, such debt will continue to be counted as Continuing Short-Term Debt and need not be counted against the Continuing Long-Term Debt limit.

IT IS FURTHER ORDERED that immediately subsequent to the issuance of any Continuing Long-Term Debt:

(a) The Company must have a minimum common equity ratio of 40% (the "Common Equity Test"). For purposes of this test, the common equity ratio is calculated as common equity divided by the sum of such common equity and the Company's long-term debt (including current maturities of long-term debt). The Common Equity Test will be calculated as of the end of the most recent calendar quarter prior to the date of calculation, adjusted to give effect to the issuance of any new indebtedness (including the proposed indebtedness for which the calculation is being made).

(b) The Company's debt service coverage ratio ("DSC") must be equal to or greater than 1.0. For purposes of this test, the DSC is calculated as operating income plus depreciation and amortization plus income tax, divided by interest on short-term and long-term debt, using the most recent audited financial statements adjusted to reflect the interest impact of changes to

outstanding debt to the date of calculation, calculated as the annualized interest at the actual interest rate on any new debt issued after the 12 month period covered by the applicable audited financial statements and remaining outstanding on the date of calculation and further including for purposes of this calculation, the annualized interest at the expected interest rate on the new long-term debt to be issued or incurred and for which the DSC calculation is being made.

IT IS FURTHER ORDERED that changes in United States generally accepted accounting principles ("GAAP") or changes in the interpretation of GAAP (collectively, "GAAP Changes") shall be treated as follows:

(a) Any contract or other legally-binding arrangement to which the Company is a party as of the date of this Order (the "Existing Obligations") will not be considered indebtedness for purposes of this Order, including the Continuing Long-Term Debt limit, the Continuing Short-Term Debt limit, the Common Equity Test, and the DSC, if the Existing Obligation was not considered indebtedness under GAAP as of the date of this Order, even if a GAAP Change subsequently occurs that results in an Existing Obligation being considered indebtedness. The Company will notify the Commission of any GAAP Change that results in an Existing Obligation being classified as indebtedness within 30 days after the Company files its Quarterly Report on Form 10-Q or its Annual Report on Form 10-K with the Securities and Exchange Commission following the end of the fiscal quarter in which such GAAP Change occurs (the "Notification Period").

(b) If, after the date of this Order, the Company enters into a contract or other legally-binding arrangement that is not considered indebtedness under GAAP but subsequently is considered indebtedness because of a GAAP Change, the Company's obligations under such contract or other legally-binding arrangement will not be considered indebtedness for purposes



of this Order, including the Continuing Long-Term Debt limit, the Continuing Short-Term Debt limit, the Common Equity Test, and the DSC, until further Commission action if, within the Notification Period, the Company files an application with the Commission specifically requesting approval of such reclassified debt obligations.

IT IS FURTHER ORDERED that the authorizations to incur short-term and long-term debt obligations provided in this Order shall replace all existing authorizations for the incurrence of short-term and long-term debt, and all such existing authorizations shall terminate upon the effective date of this Order. Notwithstanding the above, the Commission's Decision No. 55120 (July 24, 1986) and Decision No. 55320 (December 5, 1986) (the "Sale-Leaseback Authorizations") will remain in full force and effect.

IT IS FURTHER ORDERED that the short-term and long-term debt levels authorized in this Order will terminate on December 31, 2012, provided that all short-term and long-term debt outstanding at December 31, 2012 that was previously authorized pursuant to this Order shall remain authorized and valid obligations of the Company. The December 31, 2012 termination date will be extended until the Commission issues a new financing order replacing the then-existing order, provided that (a) the Company files an application for a new financing order on or before December 31, 2011 and (b) the Commission has not issued an order pursuant to such application on or before December 31, 2012.

IT IS FURTHER ORDERED that on each occasion when the Company enters into a new long-term debt agreement, the Company must file with Docket Control a description of the transaction and a demonstration that the rates and terms are consistent with those generally available to comparable entities at the time. No such filing need be made for any such new long-

term debt agreement not involving traditional indebtedness for borrowed money or that has a principal value of less than \$5 million.

IT IS FURTHER ORDERED that the Company is hereby authorized to sign and deliver such documents and to engage in such acts as are reasonably necessary to effectuate the authorizations granted hereinabove.

IT IS FURTHER ORDERED that the purposes for which the proposed issuances of Continuing Long-Term Debt and the Continuing Short-Term Debt are herein authorized are to augment the funds available from all sources to finance the Company's construction, resource acquisition and maintenance programs, to redeem or retire outstanding securities, to repay or refund other outstanding long-term or short-term debt and to meet certain of the Company's working capital and other cash requirements. Such purposes are within those permitted by A.R.S. Section 301 and are permitted regardless of the extent to which they may be reasonably chargeable to operating expenses or to income.

IT IS FURTHER ORDERED that Pinnacle West is hereby authorized under A.C.C. R14-2-803 to guarantee the Company's indebtedness from time to time in indeterminate amounts. The Company is hereby authorized to reimburse Pinnacle West for any amounts paid by Pinnacle West under any guarantee of the Company's debt from time to time, along with interest thereon to the date of reimbursement at a rate of interest not greater than the rate payable on the debt so guaranteed and paid by Pinnacle West.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

1879023.7

# Exhibit 3

## Public Notice of Hearing



Susan Casady  
Supervisor  
Regulatory Affairs

Tel. 602-250-2709  
Fax 602-250-3003  
e-mail Susan.Casady@aps.com

Mail Station 9708  
PO Box 53999  
Phoenix, Arizona 85072-3999

5090

July 5, 2007

Docket Control  
Arizona Corporation Commission  
1200 West Washington Street  
Phoenix, Arizona 85007

RE: PUBLIC NOTICE UNDER DOCKET NO. E-01345A-06-0779

Dear Sir or Madame:

Pursuant to the Procedural Order dated June 22, 2007, Arizona Public Company ("APS") was ordered to provide public notice of the hearing in this matter to its customers giving them the opportunity to file a motion to intervene or comments with Docket.

Attached are copies of the required Public Notice published within APS' service territory that ran in the Arizona Republic on June 30, 2007 (Tear Sheet) and the Affidavit of Publication.

Sincerely,

Susan Casady  
Compliance and Document  
Management Supervisor

SC/dk

Attachments

CC: Docket Control (Original, plus 13)

AZ CORP COMMISSION  
DOCKET CONTROL

2007 JUL -6 A 8:34

RECEIVED

Arizona Corporation Commission  
**DOCKETED**

JUL -6 2007

DOCKETED BY	NR
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## **PUBLIC NOTICE OF HEARING ON ARIZONA PUBLIC SERVICE COMPANY AND PINNACLE WEST CAPITAL CORPORATION'S FINANCING APPLICATION DOCKET NO. E-01345A-06-0779**

On December 15, 2006, Arizona Public Service Company ("APS") and Pinnacle West Capital Corporation ("PWCC") filed a joint application ("Application") with the Arizona Corporation Commission ("Commission") for authorization to issue long-term debt up to a cap of \$4.2 billion and short-term debt up to a cap equaling the sum of 7 percent of the Company's capitalization plus \$500 million. The Application also requested an ongoing waiver for PWCC to guarantee the indebtedness of APS from time to time. The Commission's Staff has filed a Staff Report with its recommendations on the Application.

The Commission will hold a hearing on this matter beginning at 10:00 a.m. on July 23, 2007 at the Commission's offices, 1200 West Washington Street, Phoenix, Arizona 85007. Public Comments will be taken in Phoenix at the beginning of hearing. Copies of APS and PWCC's application are available at its office 400 N. 5<sup>th</sup> Street, Phoenix, AZ 85004, on the internet via the Commission website ([www.azcc.gov](http://www.azcc.gov)) using the e-docket function, and at the Commission's offices for public inspection during regular business hours.

The law provides for intervention in the Commission's proceedings on the application by any person having a direct and substantial interest in the matter. Persons desiring to intervene must file a written motion to intervene with the Commission, which motion should be sent to the Company or its counsel and to all parties of record, and which, at the minimum, shall contain the following:

1. The name, address, and telephone number of the proposed intervenor and of any party upon whom service of documents is to be made if different than the intervenor.
2. A short statement of the proposed intervenor's interest in the proceeding (e.g., a customer of the Company, a stockholder of the Company, etc.).
3. A statement certifying that a copy of the motion to intervene has been mailed to the Company or its counsel and to all parties of record in the case.

The granting of motions to intervene shall be governed by A.A.C. R14-3-105, except that all motions to intervene must be filed on or before July 11, 2007. The granting of intervention, among other things, entitles a party to present sworn evidence at hearing and to cross-examine other witnesses. However, failure to intervene will not preclude any customer from appearing at the hearing and making a statement on such customer's own behalf.

For information about requesting intervention, visit the Arizona Corporation Commission's webpage at <http://www.azcc.gov/utility/forms/index.htm>. Any person may file written comments on the application, without seeking intervention, by mailing copies to the Commission, APS and PWCC. Requests to intervene and written comments should include the docket number E-01345A-06-0079.

If you have any substantive questions about this application you may contact the Company at: Susan Casady, Compliance and Document Management Supervisor, 400 N. 5<sup>th</sup> Street, Phoenix, AZ 85004, 602-250-2709, [Susan.Casady@aps.com](mailto:Susan.Casady@aps.com).

If you wish to file written comments regarding the application, or want further information on intervention, you may contact the Consumer Services Section of the Commission at 1200 West Washington Street, Phoenix, Arizona 85007, or call 1-800-222-7000.

The Commission does not discriminate on the basis of disability in admission to its public meetings. Persons with a disability may request a reasonable accommodation such as a sign language interpreter, as well as request this document in an alternative format, by contacting the ADA Coordinator Linda Hogan, E-mail [Lhogan@azcc.gov](mailto:Lhogan@azcc.gov), voice phone number 602-542-3931. Requests should be made as early as possible to allow time to arrange the accommodation.

## THE ARIZONA REPUBLIC

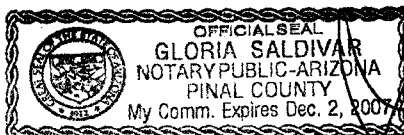
STATE OF ARIZONA }  
COUNTY OF MARICOPA } SS.

Marilyn Greenwood, being first duly sworn, upon oath deposes and says: That she is a legal advertising representative of the Arizona Business Gazette, a newspaper of general circulation in the county of Maricopa, State of Arizona, published at Phoenix, Arizona, by Phoenix Newspapers Inc., which also publishes The Arizona Republic, and that the copy hereto attached is a true copy of the advertisement published in the said paper on the dates as indicated.

**The Arizona Republic**

**June 30, 2007**

Sworn to before me this  
5<sup>TH</sup> day of  
July A.D. 2007



*Marilyn Greenwood*  
*Gloria Saldivar*  
Notary Public